

# **Preventing Future Economic Crises Through Consumer Protection Law or How the Truth in Lending Act Failed the Subprime Borrowers**

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*This Article argues that one cause of the current economic crisis was that the federal Truth in Lending Act (TILA) failed to provide mortgage borrowers with the tools to determine whether they would be able to meet their loan obligations, and that as a result many borrowers assumed loans on which they would later default. The Article first explores the disclosures for adjustable-rate mortgages—which were commonly used for subprime loans—and explains how those disclosures misled borrowers about their monthly payments. Next, the Article reports on a survey of mortgage brokers conducted in July of 2009. The brokers were nearly unanimous in reporting that borrowers never withdrew from a loan after reading the final TILA disclosures at the closing and never used those disclosures for their stated purpose of comparison shopping for loans. In addition, brokers reported that many borrowers spent a minute or less with the disclosures, despite the fact that mortgage loans are among the largest, longest-term, and most complex obligations most consumers ever assume. It thus appears that many borrowers enter into their mortgages without comprehending the terms and the ramifications of those loans.*

*The Article suggests several measures to increase the likelihood that borrowers will attend to and understand their loan terms. At present, disclosures are mandated by governmental entities that do not participate in the loan transaction—thereby reducing their control over how the disclosures are presented; provided by lenders who do not have a stake in having consumers understand the disclosures and in some cases have an interest in obscuring them; and received by consumers who may not appreciate their importance and may even have reasons to overlook them. The Article therefore suggests a switch from the current TILA disclosure regime to a comprehension regime under which lenders would be obliged to insure that borrowers understand their loan terms. Alternatively, the Article*

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*suggests that lenders should be required to determine what proportion of their borrowers understand their loan terms and disclose those figures with the goal of generating competition among lenders for better comprehension scores. The hope is that either choice would give a party to the loan transaction—the lender—a stake in borrowers understanding their loan terms. Creation of such an incentive might cause lenders to reduce distractions to consumers reading disclosure forms, enlist the aid of lenders in conveying key terms to consumers, increase the intelligibility of loan terms, and lead lenders to abandon loan terms that consumers cannot comprehend.*

*If such a proposal proves politically unfeasible, the Article also draws on the work of Cass Sunstein and Richard H. Thaler to suggest “nudges” that might enhance the current disclosure regime. Specifically, the Article advocates requiring borrowers to view a video of the pain and risk of default and foreclosure to make those risks more salient and increase the likelihood that consumers attend to disclosures. The Article also suggests that loan applicants be obliged to draft a budget, taking into account any future increases in loan payments, so that they will understand the consequences of their payment obligations. Finally, the Article calls for requiring borrowers to take a “placement exam” to demonstrate their mastery of their loan terms and the budgetary consequences. Those who fail the exam would not be permitted to borrow unless a neutral credit counselor worked with them and certified that they understand their loan terms.*

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## I. INTRODUCTION

The goal of this Article is to tell a story that goes like this: the economic crisis that hit in 2008 had many causes, among which was the failure of the Truth in Lending Act (TILA).<sup>1</sup> TILA, intended to enable consumers to borrow wisely, not only failed the subprime borrowers in that goal, but in fact was interpreted to require lenders to provide misleading disclosures which might have persuaded borrowers that their loans were more affordable than they would turn out to be. Perhaps as a result, many borrowers seem to have taken on loan obligations that were inappropriate for their circumstances. Had borrowers better appreciated their loan terms, some would not have assumed payment obligations they could not meet, fewer borrowers would have defaulted, and the economic crisis might have been less severe. The remainder of this introduction fleshes out this story, and the balance of the Article substantiates the claims made in this introduction and suggests changes in the law to address the problem.

In the years preceding the economic crisis, consumers entered into ill-fated loans for many reasons. Some borrowers, who may actually have understood their obligations, gambled that home prices would continue rising, thus enabling them to repay their loans by selling at a profit or refinancing at lower rates.<sup>2</sup> Some may have been crooks, intending to defraud lenders into making loans that would never be repaid.<sup>3</sup> But others did

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<sup>1</sup> Truth in Lending Act of 1968, 15 U.S.C. § 1601 *et seq.* (2006).

<sup>2</sup> At least some subprime borrowers appear to have been speculators. See Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 33–34 (2009) (Home Mortgage Disclosure Act (HMDA) data shows that “since 2000 the percentage of subprime loans that are for *non-owner-occupied* home loans—[i.e.,] to fund the purchase of rental or vacation homes . . . has doubled from about 8% of all subprime loans to over 16%” and suggests that many defaulters bought for speculation).

<sup>3</sup> See generally Carolyn Said, *Mortgage Meltdown: Plenty of Blame for Lending Mess*, S.F. CHRON., Feb. 3, 2008, at C4 (No-documentation loans “were dubbed ‘liar

not understand their payment obligations and entered into loans that they did not understand they could not repay, with dreadful consequences for themselves, their families, communities, and the economy.<sup>4</sup> Those consequences include about 1.7 million foreclosures by June 30, 2009 in nonprime loans originated from 2000 through 2007, or about 12% of those loans.<sup>5</sup> More than a quarter of the borrowers on those loans were seriously delinquent, defined as either in foreclosure proceedings or at least ninety days behind in payments, while less than two-thirds were current on their payments.<sup>6</sup> Commentators have estimated the number of foreclosures in 2009 alone as 2.4 million,<sup>7</sup> with as many as 13 million through 2014.<sup>8</sup>

As the economic crisis demonstrates, society as a whole has an interest in insuring that loans are repaid. One check on whether consumers can repay a loan is the consumer herself. But when consumers do not understand their payment obligations, and so underestimate them, that check disappears. That would matter less if lenders could predict with complete certainty which consumers will default and so would deny loans to borrowers unlikely to repay them. But the economic crisis makes clear that models for predicting which consumers will default are not sufficiently reliable, or that some lenders were willing to lend to those at significant risk of being unable to repay their loans, or both.<sup>9</sup> For example, in 2007, an official at one of the

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loans' for a reason. Janitors claimed six-figure salaries and were able to buy half-million-dollar homes."); MERLE SHARICK ET AL., MORTG. ASSET RESEARCH INST., NINTH PERIODIC MORTGAGE FRAUD CASE REPORT TO MORTGAGE BANKERS ASSOCIATION (Apr. 2007), *available at* <http://www.mortgagefraudblog.com/images/uploads/MBA9thCaseRpt.pdf>.

<sup>4</sup> See *infra* notes 216–19 and accompanying text.

<sup>5</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-146R, LOAN PERFORMANCE AND NEGATIVE HOME EQUITY IN THE NONPRIME MORTGAGE MARKET 7 (2009) [hereinafter GAO: LOAN PERFORMANCE], *available at* <http://www.gao.gov/new.items/d10146r.pdf>.

<sup>6</sup> *Id.*

<sup>7</sup> CTR. FOR RESPONSIBLE LENDING, SOARING SPILLOVER: ACCELERATING FORECLOSURES TO COST NEIGHBORS \$502 BILLION IN 2009 ALONE; 69.5 MILLION HOMES LOSE \$7,200 ON AVERAGE 1 (May 2009) [hereinafter SOARING SPILLOVER], *available at* <http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf>.

<sup>8</sup> See JAN HATZIUS & MICHAEL A. MARSCHOUN, GOLDMAN SACHS GLOBAL ECS RESEARCH, HOME PRICES AND CREDIT LOSSES: PROJECTIONS AND POLICY OPTIONS 16 (Jan. 13, 2009), *available at* <http://media.garygreene.com/file.php/216/Global+Paper+No++177.pdf>.

<sup>9</sup> See Truth in Lending, 73 Fed. Reg. 44,526 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) ("The recent sharp rise in serious delinquencies on subprime mortgages has made clear that originators were not adequately assessing repayment ability,

nation's largest subprime mortgage lenders, Countrywide Financial, testifying before a congressional committee about hybrid adjustable-rate mortgages (ARMs) that carried an initial low rate but would later switch to an adjustable rate, estimated that "about 60 percent of the people who do qualify for the hybrid ARM's would not be able to qualify at the fully indexed rate."<sup>10</sup> In other words, Countrywide anticipated that many borrowers would

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particularly where mortgages were sold to the secondary market and the originator retained little of the risk.”).

<sup>10</sup> *Mortgage Market Turmoil: Causes and Consequences: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. 52 (2007) (testimony of Sandor Samuels, Executive Managing Director, Countrywide Financial Corporation); see also *Public Hearing Before the Fed. Reserve Bd.: Building Sustainable Homeownership: Responsible Lending and Informed Consumer Choice* 121 (2006) (hearing before Fed. Reserve Bank of Atlanta) [hereinafter *Atlanta Public Hearing*] (statement of Doug Duncan, Senior Vice President and Chief Economist, Mortgage Bankers Association), available at <http://www.federalreserve.gov/events/publichearings/hoepa/2006/20060711/transcript.pdf> (“[A] significant portion of loans are not underwritten at the fully indexed rate.”); Option One Mortg. Acceptance Corp., Prospectus, at S-5, S-50 (Apr. 29, 2005), <http://www.sec.gov/Archives/edgar/data/1025562/000088237705001135/d328276.txt> (“In determining the ability of the applicant to repay the loan, a rate . . . has been created under the Option One Underwriting Guidelines that generally is equal to the lesser of the fully indexed interest rate on the loan being applied for or one percent above the initial interest rate on such loan.”).

The fully indexed rate on many loans will exceed one percent above the initial interest rate, and in fact the Prospectus also indicates that for one set of loans the weighted average initial rate adjustment cap of the adjustable-rate mortgage loans was 2.988%, which obviously exceeds 1%. See *id.* at S-5; see also ILL. DEP’T FIN. AND PROF’L REGULATION, FINDINGS FROM THE HB 4050 PREDATORY LENDING DATABASE PILOT PROGRAM 1 (2007), available at <http://www.nlihc.org/doc/repository/IL-Findings.pdf> (review of data collected by counseling agencies in Chicago in mandatory counseling program found that “in the majority of cases [in which borrowers obtained adjustable-rate loans] borrowers were being approved for financing solely on the basis of the initial or ‘teaser’ rate, without regard to the borrower’s ability to afford the loan when the rate adjusted”); ELLEN SCHLOEMER ET AL., CTR. FOR RESPONSIBLE LENDING, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 5, 26 (Dec. 2006), <http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf> (“Subprime lenders who market exploding ARM’s and other high-risk loans often do not adequately consider whether the homeowner will be able to pay when the loan’s interest rate resets, even if rates stay constant. . . . Subprime lenders’ public disclosures indicate that some are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate can rise significantly, giving the borrower a higher monthly payment.”); Paul Leonard & Michael Calhoun, *Calculated Risk: Assessing Nontraditional Mortgage Products*, COMMUNITY INVESTMENTS 15, 15–16 (Dec. 2006), available at <http://www.frbsf.org/publications/community/investments/0612/leonard.pdf>. But see U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-06-1112T, ALTERNATIVE

not be able to make their payments once the temporary teaser rates expired, unless the borrowers' financial circumstances improved dramatically—something which seems unlikely to happen to 60% of their hybrid ARM borrowers—or interest rates were to fall substantially, another risky bet. No doubt Countrywide anticipated that home prices would increase enough to support refinancing, something that of course did not occur and that hindsight makes clear could not have continued indefinitely.<sup>11</sup> Indeed, some loans seemed virtually to invite default. Thus, a Countrywide manual approved the making of loans that left consumers as little as \$550 a month to live on, or \$1,000 for a family of four.<sup>12</sup>

Under those circumstances, the ability of consumers to decline loans they cannot repay becomes a key restraint on unwise lending.<sup>13</sup> In a sense, lending decisions contain a built-in comparative advantage mechanism. Lenders are able to predict which borrowers will default based on their extensive experience with lending and their computer models, and that gives lenders some advantages in predicting who will default. But borrowers know something about themselves, their needs, their expectations, their spending habits, and so on—giving them an advantage in predicting whether they can

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MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED 6 (2006) [hereinafter GAO: ALTERNATIVE MORTGAGE PRODUCTS] (reporting that “OCC and Federal Reserve officials told us that most lenders qualify payment-option ARM borrowers at fully indexed rates, not at introductory interest rates, to help ensure that borrowers have financial resources to manage future mortgage increases”). This contrasts with an example used earlier in the GAO report, discussed *infra* notes 215–16, in which the GAO noted that a borrower's payments would increase to an amount substantially higher than the monthly payment used to qualify the borrower.

<sup>11</sup> For discussions of how some predicted that housing prices would fall and that they were in a bubble, see JOSEPH E. STIGLITZ, *FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY* (Joseph E. Stiglitz ed., 2010) (arguing that rise in housing prices was unsustainable because median incomes were stagnant).

<sup>12</sup> See Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, at 9.

<sup>13</sup> Cf. Governor Edward M. Gramlich, Subprime Lending, Predatory Lending, Remarks at the Federal Reserve Bank of Philadelphia, Community and Consumer Affairs Dep't Conference on Predatory Lending (Dec. 6, 2000), available at <http://www.federalreserve.gov/boarddocs/speeches/2000/20001206.htm> (“[T]he best defense against predatory lending is a thorough knowledge on the part of consumers of their credit options and resources.”); Valentina Hartarska et al., *Credit Counseling and the Incidence of Default on Housing Loans by Low-Income Households* iii (The Ohio State Univ. Rural Fin. Program, Working Paper No. 02P3, 2002), available at <http://aede.osu.edu/programs/ruralfinance/PDF%20Docs/Publications%20List/Papers/02P03.pdf> (“The evidence . . . suggests that the ability to pay . . . plays an important role in determining the incidence of default.”).

meet loan obligations based on information not included in lenders' computer models, perhaps because it is too expensive to ascertain.<sup>14</sup> As a result, borrowers have some capacity to predict that they will not be able to repay loans. But they cannot exercise that capacity if they do not understand the loan terms well enough to measure them against their knowledge. Accordingly, policy-makers should adopt rules that will ensure that consumers understand their payment obligations well enough to permit them to decline unwise loans. Existing law does not accomplish that for enough borrowers. While the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>15</sup> (Dodd-Frank Act), signed into law on July 21, 2010, bars lenders from making residential mortgage loans unless the creditor makes a "reasonable and good faith determination" that the borrower has a "reasonable ability to repay [the loan],"—surely a step forward in addressing this problem—the Dodd-Frank Act does not eliminate the borrower's comparative advantage in determining some loan defaults and so cannot by itself completely eliminate such defaults.<sup>16</sup>

This Article is based on three assumptions: first, that many consumers will not deliberately assume loan obligations they know they will not be able to discharge; second, that consumers need aid in determining loan terms and why they should attend to them; and third, that it is possible to reconstruct disclosure laws to provide that aid. The first assumption is obviously not true of dishonest borrowers. In addition, some speculators may have been willing to assume a substantial risk of default. But it appears likely that a significant number of consumers would not have willingly set off down the path to foreclosure if they had understood what they were binding themselves to do. Of course, even if that assumption is wrong, disclosure laws are valuable for other reasons, including those recognized in TILA itself: they are intended to help consumers choose among competing offers and at least theoretically produce more efficient transactions.<sup>17</sup> As a result, improving consumer

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<sup>14</sup> As discussed below, what borrowers know may sometimes lead them to excessive optimism, and so this may not be a perfect restraint, though there may be ways to counteract the optimism bias. *See infra* note 167 and accompanying text.

<sup>15</sup> Pub. L. No. 111-203, 124 Stat. 1376 (to be codified as amended in scattered titles and sections of the U.S. Code).

<sup>16</sup> *See* Dodd-Frank Act § 1411, 124 Stat. 2142–43 (adding new section 129C to the Truth in Lending Act).

<sup>17</sup> TILA's purpose is stated at 15 U.S.C. § 1601:

The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of

comprehension of loan terms seems, all other things being equal, a worthy goal.

Part II of the Article attempts to provide empirical support for the second assumption and also to demonstrate that the laws in place during the years in which the subprime loan buildup occurred did not provide the aid consumers needed in making borrowing decisions. Part II opens by demonstrating how existing disclosures are misleading. It then reports on a survey of mortgage brokers that suggests that borrowers do not take account of federally-mandated disclosures of their final loan terms in deciding whether to borrow, and that many spend too little time with those disclosures to understand their loan terms well enough to make appropriate decisions. Part II also relies on existing scholarship to support the conclusion that law-makers must provide borrowers more help if borrowers are to make optimal borrowing decisions—the kinds that will keep them from assuming loan obligations on which they will later default.

Part III discusses some strategies to test the third assumption. Specifically, Part III suggests ways to increase the probability that consumers contemplating borrowing substantial sums pay sufficient attention to and understand their payment obligations well enough to make appropriate judgments about whether they can meet those obligations. It first suggests a reform that is unlikely to be adopted but that offers a better solution to the problem than the current disclosure regime. Specifically, the Article suggests switching to a comprehension regime, in which lenders would be obliged to demonstrate that a certain percentage of their borrowers understood their loan terms, and which gives lenders some flexibility in determining how to convey those terms. Such a regime has the benefit of changing the incentives lenders face from one in which they are largely indifferent to whether consumers make appropriate borrowing decisions—as long as the lenders can demonstrate that they have made the required disclosures—to one in which lenders have an incentive to insure that borrowers actually comprehend loan terms, which should enable consumers to make appropriate decisions. It also enables consumers to benefit from the power of lenders to convey information to consumers—something at which lenders have considerable skill, as their advertising campaigns indicate—as opposed to the current regime, which depends on governmental agencies which are not themselves

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credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit . . . .

Commentators have identified many other goals for TILA. For a list of thirty-eight such goals, see Thomas A. Durkin & Gregory Elliehausen, *Disclosure as a Consumer Protection*, in *THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT* 114 (Thomas A. Durkin & Michael E. Staten eds., 2002).



involved in the lending transactions to figure out how lenders should best communicate loan terms to consumers.

On the assumption that converting to a comprehension regime is politically impossible, Part III next explores some strategies that would increase the likelihood that disclosures benefit consumers. First, the Article draws on Richard H. Thaler and Cass R. Sunstein's book *Nudge*<sup>18</sup> to suggest that consumers need a "nudge" to read loan disclosure forms; for example, a short video that would bring home to consumers the pain caused by foreclosure might encourage them to read the forms. Second, the Article suggests that consumers be tested on their comprehension of their loan terms. Those who demonstrate comprehension can then proceed to closing, assuming that they still wish to do so. Those who fail the test will be barred from borrowing until a disinterested loan counselor—not a mortgage broker—certifies that the would-be borrower understands the loan terms. Part III then justifies this paternalistic approach to lending regulation and explains why it is preferable to the current disclosure regime.

## II. THE TILA DISCLOSURES MISLED BORROWERS AND DID NOT GIVE BORROWERS THE TOOLS THEY NEEDED TO KEEP FROM BORROWING UNWISELY

### A. *The Loan Terms Themselves*

TILA was inspired in part by a view that consumers needed aid in understanding loan terms to make optimal borrowing decisions.<sup>19</sup> The reasons for this position became, if anything, stronger in the decades after TILA's enactment, as loan terms became even more complex, with, for example, such innovations as ARMs and payment option ARMs.<sup>20</sup> Consider, for example, the following term, taken from a note for a 2004 "2/28 loan"—a

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<sup>18</sup> RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008).

<sup>19</sup> See *supra* note 17.

<sup>20</sup> Adjustable-rate loans are loans in which the interest rate, and consequently the monthly payments, shift from time to time. Vincent DiLorenzo, *Mortgage Market Deregulation and Moral Hazard: Equity Stripping Under Sanction of Law* 38 (St. John's Legal Studies Research Paper No. 09-0179, 2009), available at <http://ssrn.com/abstract=1488293> ("In payment option loans the borrower can choose to pay a minimum payment which does not include all accrued interest and does not include payment of principal. . . . The accrued and unpaid interest is then added to the principal. However, when the outstanding balance reaches a certain threshold—typically 115% of fair market value [of the mortgaged property]—then the payment option expires and the loan is recast to require monthly payments of both interest and principal.").

common type of subprime loan, under which borrowers pay a low “teaser” rate for the first two years, after which the loan becomes adjustable for the remaining 28 years, often with an adjustment every six months.<sup>21</sup>

#### 4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

##### (A) Change Dates

The interest rate I will pay may change on the first day of June, 2006, and on that day every sixth month [sic] thereafter. Each date on which my interest rate could change is called a “Change Date.”

##### (B) The Index

Beginning with the first Change Date, my interest rate will be based on an Index. The “Index” is the average of interbank offered rates for six-month U.S. dollar-denominated deposits in the London market (“LIBOR”), as published in The Wall Street Journal. The most recent Index figure available as of the date 45 days before the Change Date is called the “Current Index.”

If at any point in time the Index is no longer available, the Note Holder will choose a new index that is based upon comparable information. The Note Holder will give me notice of this choice.

##### (C) Calculation of Changes

Before each Change date, the Note Holder will calculate my new interest rate by adding six percentage point(s) (6.000%) to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth [sic] of one percent (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date. The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid

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<sup>21</sup> See *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 110th Cong. 102 (2008) (statement of Hilary Shelton, Director, NAACP Washington Bureau) (“[O]ver 80% of home loans made in the subprime market today are adjustable rate mortgage (ARMs) loans and the so-called ‘2/28’ or ‘3/27’ mortgages are the dominant product.”); GAO: LOAN PERFORMANCE, *supra* note 5, at 5 n.10 (“[S]hort-term hybrid ARMs [which would include a 2/28 loan] represented about 70 percent of the subprime mortgages originated from 2000 through 2007.”); Christopher Mayer et al., *The Rise in Mortgage Defaults*, 23 J. ECON. PERSP. 27, 30 (2009) (“The overwhelming majority—over 75 percent—of subprime mortgages that originated over the 2003–2007 period were so-called ‘short-term hybrids’ . . . .”); Mara Lee, *Subprime Mortgages: A Primer*, NPR (Mar. 23, 2007), <http://www.npr.org/templates/story/story.php?storyId=9085408> (“The vast majority [of subprime loans]—about 80 percent—have adjustable-rate mortgages, or ARMs, says Susan Wachter, a professor at the University of Pennsylvania’s Wharton School who specializes in real estate.”). According to the Federal Reserve, “[a]pproximately three-quarters of securitized originations in subprime pools from 2003 to 2007 were 2-28 or 3-27 ARMs . . . .” Truth in Lending, 73 Fed. Reg. 44,540 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226).

principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

(D) Limits on Interest Rate Changes

The Interest rate I am required to pay at the first Change Date will not be greater than 8.300% or less than 6.300%. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than One percentage point(s) (1.000%) from the rate of interest I have been paying for the preceding six months. My interest rate will never be greater than 12.300% or less than 6.300%.

(E) Effective Date of Change

My new interest rate will become effective on each Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes

The Note Holder will deliver or mail to me a notice of any changes in my interest rate and the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given me and also the title and telephone number of a person who will answer any question I may have regarding the notice.<sup>22</sup>

It is not clear how many borrowers actually read such terms, much less understand them, especially since borrowers might see them for the first time at the closing, when they are also confronted with numerous other legal documents, and perhaps urgings from others present to sign the documents as quickly as possible. But borrowers—and readers of this Article—who struggled through that language may be dismayed to learn that it is often superseded by an adjustable-rate rider appended to the note, which provides still another term for calculating the monthly payments.<sup>23</sup> Whatever the number of borrowers who read the original term, probably even fewer then proceeded to read through the adjustable-rate rider. No doubt some borrowers found it unnecessary to read either term on the theory that the TILA disclosures made doing so unnecessary. But as will be discussed

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<sup>22</sup> Adjustable Rate Note (on file with author). For an example of a case quoting a note using some of this language, see *Leisy v. First E. Corp.*, No. 3:91CV305, 1991 WL 1179813, at \*3 (M.D. Pa. Sept. 17, 1991); *see also* Complaint for Rescission of Mortgage and Damages at 31–35, *Frazile v. EMC Mortg. Corp.*, No. 1:09-cv-21636-AJ (S.D. Fla. June 15, 2009) (note appended to complaint).

<sup>23</sup> For an example of cases involving a note including such a rider, see *Frazile v. EMC Mortg. Corp.*, No. 09-15560, 2010 WL 2331429 (11th Cir. June 11, 2010); *O'Donnell v. Bank of Am.*, No. C-07-04500 RMW, 2009 WL 765670 (N.D. Cal. Mar. 20, 2009).

below, those disclosures are misleading, and in any event, many borrowers gave them little attention.

### B. *The TILA Disclosures*

Most subprime loans carry adjustable rates, and so this section explains the mandated disclosures for adjustable-rate loans.<sup>24</sup> Because by definition, adjustable mortgage loan rates and monthly payments vary from time to time with fluctuations in interest rates, it is impossible for the disclosure forms provided at the closing to state what the payments will be once the loan reaches the first date when the rates and payment amounts change. The Federal Reserve Board, which was charged with interpreting and implementing TILA, therefore came up with a three-step approach for dealing with these products.<sup>25</sup> First, lenders were obliged to provide two sets of documents to consumers contemplating taking out an adjustable-rate loan (“the early disclosures”). The first of these was a booklet published by the government called the “Consumer Handbook on Adjustable-Rate Mortgages,” commonly called the CHARM booklet.<sup>26</sup> The second early disclosure is a set of materials about any program into which consumers inquire. The Federal Reserve’s Model Form for these program disclosures for variable loan clauses appears in Figure One. The program disclosures, as in Figure One, may include a historical example of how payments shift over time.<sup>27</sup> In addition, in some cases, within three days after the borrower submitted a loan application, originators were obliged to supply good faith estimates (GFEs) of loan terms.<sup>28</sup> Finally, mortgage originators were required to provide the final set of disclosures by the time of consummation; that is, before the papers were signed and the loan was agreed to.<sup>29</sup>

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<sup>24</sup> See *supra* note 20 for further discussion of adjustable-rate loans.

<sup>25</sup> On July 21, 2010, the President signed into law the Dodd-Frank Act. Section 1061(b) of the statute transfers the Federal Reserve’s consumer financial protection functions, which includes responsibility for TILA, to the Consumer Financial Protection Bureau (CFPB), to be housed within, but largely independent of, the Federal Reserve. Dodd-Frank Act § 1061(b), 124 Stat. 2036.

<sup>26</sup> The CHARM booklet is available at [http://www.federalreserve.gov/pubs/arms/arms\\_english.htm](http://www.federalreserve.gov/pubs/arms/arms_english.htm).

<sup>27</sup> See 12 C.F.R. § 226.19 (2010).

<sup>28</sup> At the time many subprime loans were taken out, lenders were not required to provide such GFEs for refinancings, only for loans used to purchase homes. The Fed has since amended § 226.19 to extend the disclosure requirements to refinancings as well. See Truth in Lending, 73 Fed. Reg. 44,590 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226).

<sup>29</sup> See 12 C.F.R. §§ 226.2(a)(13), 226.17(b) (2010).

Unfortunately, the early disclosures were of only limited value to borrowers, and the final disclosures were outright misleading.<sup>30</sup>

Why were the early disclosures of only limited value? The utility of the CHARM booklet is perhaps best explained by noting that the Federal Reserve has proposed that lenders should no longer be required to supply it to borrowers.<sup>31</sup> As for the early program disclosures, and as Figure One indicates, the form has at least two defects from the point of view of someone attempting to determine what their payment obligations will be.<sup>32</sup> First, the form need not state the actual figures for the borrower's loan. Thus, the model form ungrammatically notes, "This is a margin we have used recently, your margin may be different." As a result, borrowers attempting to determine what their monthly payments will be cannot rely on the numbers provided in the form.<sup>33</sup> Second, the form is based on a \$10,000 loan, rather than on the actual amount the consumer intends to borrow. Of course, few, if any, mortgage loans are for \$10,000. While the form includes instructions on how to multiply and divide to convert the \$10,000 amount financed to the consumer's mortgage amount, it is not clear how many borrowers go through that exercise, or, for that matter, how many can,<sup>34</sup> or that they regard the information in the form as useful given that their own loan terms may vary. In short, the early disclosures do not give borrowers the information they need to determine if they can afford the monthly payments. Thus, the early disclosures did not prevent a practice observed by the Federal Reserve in 2008: "In some cases, originators mislead borrowers into entering into

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<sup>30</sup> Originators are also required to supply certain disclosures pertaining to settlement costs under the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. § 2601 *et seq.* (2006), implemented by Regulation X, 24 C.F.R. pt. 3500. These disclosures include good faith estimates provided within three days of the borrower's application and final disclosures, now provided three days before closing, but at the time of the subprime run-up, the final disclosures, known as the HUD-1, could be provided at the closing. For illustrations of the current RESPA forms, see 24 C.F.R. pt. 3500, App. A.

<sup>31</sup> See Truth in Lending, 74 Fed. Reg. 43,434 (proposed Aug. 26, 2009) (to be codified at 12 C.F.R. pt. 226). The Federal Reserve has, however, stated that it will continue to publish the CHARM booklet. *See id.*

<sup>32</sup> The form appears in 12 C.F.R. pt. 226, App. H.

<sup>33</sup> Many borrowers appear not to realize this. According to ICF Macro, a "large number [of participants in focus groups and interviews] misinterpreted the historical example table in the disclosure; for example, some thought that the historical rates shown in the table would apply to their loan in the future." ICF MACRO, SUMMARY OF FINDINGS: DESIGN AND TESTING OF TRUTH IN LENDING DISCLOSURES FOR CLOSED-END MORTGAGES vii (July 16, 2009) [hereinafter ICF MACRO REPORT], available at <http://www.federalreserve.gov/boarddocs/meetings/2009/20090723/Full%20Macro%20CE%20Report.pdf>, (report submitted to Fed. Reserve Bd.).

<sup>34</sup> See *infra* note 97 and accompanying text.

unaffordable loans by understating the payment before closing and disclosing the true payment only at closing ('bait and switch')."<sup>35</sup>

But if the early disclosures are insufficiently helpful, the final disclosure is outright misleading. Because of the inability to tell at the time of closing how rates will shift in the future, the Fed's Commentary directs originators to assume that interest rates at the time of future change dates will be identical to the rates at the time the transaction closes.<sup>36</sup> To understand just how this command can deceive borrowers, consider the disclosure form for a "2/28 loan" shown in Figure Two. The disclosure statement correctly indicates that the monthly payment for the first two years—when the teaser rate applies—is stable. After two years, under the note, the rate and monthly payment can shift every six months. But the disclosure statement shows that the monthly payment will change only once—at the two year point—and then remain the same for the remaining twenty-eight years, because, again, the lender is to assume that rates do not change for those twenty-eight years.<sup>37</sup> Of course, rates change frequently—which is one reason lenders find it desirable to use adjustable-rate loans, because it imposes the risk of rate changes on borrowers—and it is inconceivable that rates will remain the same for twenty-eight years. Accordingly, borrowers who read such disclosure statements may be misled into thinking that their payment obligations will be more stable than they are.

But that problem pales beside the fact that the disclosure statement states a monthly payment for the last twenty-eight years that may be substantially

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<sup>35</sup> Truth in Lending, 73 Fed. Reg. 44,542 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226). For more on the program disclosures, see ICF MACRO REPORT, *supra* note 33, at 17 ("None of the participants [in focus groups or interviews], including those who had recently shopped for an ARM, remembered ever receiving anything similar to the ARM loan program disclosure they were shown. . . . Participants overwhelmingly indicated they would not find the program disclosure useful and that if given the form, they would probably not read it. . . . Upon looking at the form, the first reaction of many participants was one of confusion. Several complained that it was very difficult to read due to the terminology that was used.").

<sup>36</sup> See 12 C.F.R. pt. 226 Supplement I, cmt. 226.17(c)(1)-8 (2010) (commentary on TILA):

8. *Basis of disclosures in variable-rate transactions.* The disclosures for a variable rate transaction must be given for the full term of the transaction and must be based on the terms in effect at the time of consummation. Creditors should base the disclosures only on the initial rate and should not assume that this rate will increase. For example, in a loan with an initial rate of 10 percent and a 5 percentage points rate cap, creditors should base the disclosures on the initial rate and should not assume that this rate will increase 5 percentage points.

<sup>37</sup> The form shows a slightly different payment for the final payment because of the amount of the principal due at that time.

less than the actual monthly payment required.<sup>38</sup> That is especially likely to be true if rates are low when the borrower takes out the loan. To make matters worse, the monthly payment is one of the two most important factors for borrowers in shopping among loans.<sup>39</sup> And, unlike the early program disclosure, the final TILA disclosure does not carry a warning that the actual numbers may vary from those reported.<sup>40</sup> This played into the hands of originators who wished to present loans as affordable.<sup>41</sup> Oren Bar-Gill and Elizabeth Warren have charged that such lenders “manipulate their product design to present a low monthly payment.”<sup>42</sup> But in fact the lenders need not do so, because the Fed’s Commentary did it for them.<sup>43</sup>

In short, the disclosure form is worse than useless for borrowers.<sup>44</sup> It provides a governmentally-mandated bait and switch: the bait consists of

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<sup>38</sup> The same is also true for other numbers on the disclosure form that depend on interest rates, including the finance charge and the APR.

<sup>39</sup> See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 54 n.154 (2008) (“To many consumers, the single most salient feature of the loan is the monthly payment.”); ICF MACRO REPORT, *supra* note 33, at iv (“Interest rate and monthly payment were by far the two most common terms that focus group and interview participants compared between lenders or brokers when shopping.”).

<sup>40</sup> This problem was partly addressed by the Mortgage Disclosure Improvement Act of 2008 (MDIA), Pub. L. No. 110-289, 122 Stat. 2855 (to be codified as amended at 15 U.S.C. § 1638(b)(2), and codified as amended at 15 U.S.C.A. § 1640(a) (West 2010), 12 U.S.C.A. §§ 24, 338(a) (West 2010)), which will require lenders to provide a “worst-case” scenario showing what the payments would be if interest rates went to the highest amount permitted under the note. MDIA, Pub. L. No. 110-289, 122 Stat. 2857. But that provision will not take effect until the earlier of the date upon which the Fed promulgates implementing regulations, or thirty months after July 30, 2008, the enactment date of the MDIA. See *id.* The Federal Reserve has proposed such amendments. See Truth in Lending, 74 Fed. Reg. 43,232 (proposed Aug. 26, 2009) (to be codified at 12 C.F.R. pt. 226).

<sup>41</sup> See *infra* notes 126–43 and accompanying text.

<sup>42</sup> Bar-Gill & Warren, *supra* note 39, at 54 n.154.

<sup>43</sup> The problem was not limited to 2/28 loans, but in fact applied to any adjustable loan. In addition, borrowers found the disclosures confusing. See ICF MACRO REPORT, *supra* note 33, at v, 16 (“Participants [in focus groups and interviews] were generally confused by the payment schedule shown on the current TILA statement. For example, in examining a TILA statement for a hybrid ARM, several participants incorrectly assumed that the fact that payments in the table varied over time meant that they already reflected future changes in interest rates. . . . Testing clearly showed that the current TILA payment schedule is ineffective at communicating to consumers what could happen to their payments.”).

<sup>44</sup> Cf. RICHARD BITNER, CONFESSIONS OF A SUBPRIME LENDER 133 (2008) (“The government, for all its efforts in [mortgage lending], has done more to create confusion than to protect the consumer.”); Federal Trade Commission, Federal Trade Commission

false numbers on which borrowers may rely in determining whether the loan is affordable, while the switch is to the actual payment obligations, which borrowers may not be able to meet.<sup>45</sup> That surely contributed to the fact that 42% of the short-term subprime hybrid ARMs were at least ninety days delinquent or in foreclosure proceedings by June 30, 2009.<sup>46</sup> Ironically, borrowers wishing to know their payment obligations would have done better to try to read the note setting forth their original obligations than to read the disclosure form.

Empirical testing of TILA disclosures has also found them unhelpful to consumers. Thus, a 2007 study by the Federal Trade Commission found that many borrowers were not able to determine their loan terms or the cost of their loans from the disclosures in use at the time of the study.<sup>47</sup> Many

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Workshop: Consumer Information and the Mortgage Market 133 (May 29, 2008) (unpublished conference transcript) [hereinafter FTC Workshop] (statement of Janis Pappalardo), *available at* <http://www.ftc.gov/be/workshops/mortgage/transcript.pdf> (“[W]e think that the ineffectiveness of the current federally required disclosures is likely to have contributed, at least somewhat, to the current problems in the mortgage market.”).

<sup>45</sup> For other harms, see Bar-Gill & Warren, *supra* note 39, at 63, observing that “with imperfect information and imperfect rationality, credit may seem less costly than it really is. Accordingly, more consumers will want to borrow. The economy will respond by shifting resources to meet this increased demand—a shift that, given the mistakes underlying the increased demand, leads to allocative inefficiency (since there are better uses for these resources.”

<sup>46</sup> GAO: LOAN PERFORMANCE, *supra* note 5, at 8. That compares to a figure of only 16% for fixed-rate mortgages. *Id.*

<sup>47</sup> JAMES M. LACKO & JANIS K. PAPPALARDO, FEDERAL TRADE COMMISSION BUREAU OF ECONOMICS, STAFF REPORT, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE MORTGAGE DISCLOSURE FORMS, at ES-6, 11 (2007), *available at* <http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf> (“[I]n-depth consumer interviews [of 36 consumers] found that many borrowers were confused by the current mortgage cost disclosures and did not understand key terms in the disclosure forms, such as the APR, amount financed, and discount fees. Many borrowers also did not understand important costs and terms of their own recently obtained mortgages. Many had loans that were significantly more costly than they believed, or contained significant restrictions, such as prepayment penalties, of which they were unaware. . . . [C]urrent mortgage disclosures fail to convey key mortgage costs to many consumers.”). The quantitative portion of the study also supported this conclusion. *See id.* at 69–119; *see also* IRA J. GOLDSTEIN, THE REINVESTMENT FUND, LOST VALUES: A STUDY OF PREDATORY LENDING IN PHILADELPHIA 17 (2007), *available at* [http://trfund.com/resource/downloads/policypubs/lost\\_values.pdf](http://trfund.com/resource/downloads/policypubs/lost_values.pdf) (“Several borrowers interviewed . . . reported having no knowledge that the loan they obtained was secured by their home and that they could lose their home if they were unable to keep up with the loan payments. They also reported thinking that they have one loan when they have two.”).



consumers were confused about loan terms that bore directly on their ability to repay their loans.<sup>48</sup> The study authors noted that “even respondents who understood that they had adjustable rates did not understand the potential increases they could incur. Respondents generally did not know the maximum possible interest rates that were allowed by their loans.”<sup>49</sup>

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<sup>48</sup> LACKO & PAPPALARDO, *supra* note 47, at 61–67; *see also* MICHAEL S. BARR ET AL., NEW AMERICA FOUNDATION, BEHAVIORALLY INFORMED FINANCIAL SERVICES REGULATION 8 (Oct. 2008), available at [http://www.newamerica.net/files/naf\\_behavioral\\_v5.pdf](http://www.newamerica.net/files/naf_behavioral_v5.pdf) (“Brokers and lenders offered loans that looked much less expensive than they really were, because of low initial monthly payments and hidden, costly features.”).

<sup>49</sup> LACKO & PAPPALARDO, *supra* note 47, at 28. As noted *supra* note 40, new disclosure requirements are designed to address this problem, but as discussed below, such written disclosures will still be inadequate for some borrowers. The Study elaborated at page 122:

About a fifth of the respondents viewing the current disclosure forms could not correctly identify the APR of the loan, the amount of cash due at closing, or the monthly payment (including whether it included escrow for taxes and insurance). Nearly a quarter could not identify the amount of settlement charges. About a third could not identify the interest rate or which of two loans was less expensive, and a third did not recognize that the loan included a large balloon payment or that the loan amount included money borrowed to pay for settlement charges. Half could not correctly identify the loan amount. Two-thirds did not recognize that they would be charged a prepayment penalty if in two years they refinanced with another lender (and a third did not even recognize that they “may” be charged such a penalty). Three-quarters did not recognize that substantial charges for optional credit insurance were included in the loan. Almost four-fifths did not know why the interest rate and APR of a loan sometimes differ. And nearly nine-tenths could not identify the total amount of up-front charges in the loan.

And at page 123, the authors commented that consumers “may become obligated for payments they cannot afford, such as property taxes and homeowners’ insurance that are not included in the monthly payment, or a large balloon payment they failed to recognize.” *See also State of the U.S. Economy and Implications for the Federal Budget: Hearing Before the H. Comm. on the Budget*, 110th Cong. 21 n.3 (2007) (statement of Peter Orszag, Congressional Budget Office Budget Director) (“Certain ARMs may have been among the more difficult mortgages for first-time borrowers to understand. Many of those mortgages made in recent years included teaser rates, which may have confused some borrowers about the eventual size of their mortgage payments when their mortgage rates were reset.”); GAO: ALTERNATIVE MORTGAGE PRODUCTS, *supra* note 10, at 2 (stating among reasons borrowers may not understand risks of borrowing that “mortgage disclosures can be unclearly written and may be hard to understand”). Probably some borrowers anticipated that home prices would continue to rise, thereby making it possible for them to refinance before their monthly payments soared, and so leading them to believe that possible increases in monthly payments were not relevant. But the disclosures were not sufficient to cause borrowers to take sufficient account of the

Similarly, a study of borrowers in certain Chicago zip codes found that “the overwhelming majority” of those who received adjustable-rate loans had thought their loans were for fixed rates,<sup>50</sup> while another study found that “a sizeable number of adjustable-rate borrowers report that they do not know the terms of their contracts.”<sup>51</sup>

These empirical findings are echoed in anecdotal reports that indicate that some borrowers entered into loans without understanding their terms.<sup>52</sup> Indeed, even an economics reporter for the *New York Times*, who had written

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possibility that prices would not rise. This is discussed more fully *infra* note 257 and accompanying text.

<sup>50</sup> ILL. DEP’T FIN. AND PROF’L REGULATION, *supra* note 10, at 3–4.

<sup>51</sup> Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 2 (FEDS, Working Paper No. 2006-03, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=899152](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=899152).

<sup>52</sup> See, e.g., *Atlanta Public Hearing*, *supra* note 10, at 201–02 (statement of Karen Brown, Home Defense Program, Atlanta Legal Aid Society) (describing how borrower with credit score considered prime was given adjustable-rate mortgage she thought was fixed and payments increased to \$215 while her monthly income was \$541); Rick Brundrett, *How Mounting Loans Devastated 87-Year-Old*, COLUMBIA STATE (SC), Feb. 24, 2002, at A1, available at 2002 WLNR 1738496; Bob Herbert, Editorial, *Lost in a Flood of Debt*, N.Y. TIMES, Nov. 24, 2007, at A17 (“To this day Ms. Levey does not understand what she and her husband of more than half a century had agreed to. The terms might as well have been written in Sanskrit. . . . I heard the same story again and again—decent people enticed, sometimes fraudulently, into loans they never understood and couldn’t afford.”); Bob Herbert, Editorial, *A Swarm of Swindlers*, N.Y. TIMES, Nov. 20, 2007, at A23 (“[P]redatory lenders have . . . pushed overpriced loans and outlandish fees on hapless victims who didn’t understand—and could not possibly have met—the terms of the contracts they signed. . . . A lawyer, William Spielberger, . . . said [mortgage originators] . . . were fully aware that the two women did not know what they were getting into.”); Gretchen Morgenson, *Looking for the Lenders’ Little Helpers*, N.Y. TIMES, July 12, 2009, at BU1 (borrowers allege that lender promised fixed-rate loan when loan was actually adjustable, something borrowers did not discover until two years later; initial monthly payments consumed 45% of borrowers’ income and later rose); Lisa Prevost, *The Fallout of Subprime Loans*, N.Y. TIMES (July 15, 2007), <http://www.nytimes.com/2007/07/15/realestate/15wczo.html?ex=1342152000&en=51502d66d5337e7d&ei=5088> (“A ‘staggering number’ of homeowners who are reaching out to the Consumer Law Group, a law firm in Rocky Hill, Conn., for help in avoiding foreclosure don’t understand their loans’ terms, said Daniel Blinn, managing attorney at the firm.”); Carolyn Said, *Mortgage Meltdown: Plenty of Blame for Lending Mess*, S.F. CHRON., Feb. 3, 2008, at C1 (“Many home buyers say they were misled or didn’t understand the terms of their loans, particularly the ‘exploding ARMs’ that adjusted to stratospheric rates after a low introductory period.”); Carolyn Said, *Living the American Nightmare*, S.F. CHRON., July 29, 2007, at A1.

articles about mortgages, took out a mortgage without comprehending his loan terms.<sup>53</sup>

### *C. The Survey of Mortgage Brokers*

In July 2009, in an effort to determine how borrowers use the TILA disclosures, I had my research assistant, Sabihul Alam, conduct a telephone survey of mortgage brokers. Ultimately he spoke to 102 brokers, who reported that they had collectively attended more than 58,125 closings.<sup>54</sup> The brokers were virtually unanimous in saying that borrowers never withdrew from a loan after reading the final disclosures at the closing, and never used those disclosures for their stated purpose of comparison shopping for loans.<sup>55</sup>

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<sup>53</sup> See Edmund L. Andrews, *My Personal Credit Crisis*, N.Y. TIMES MAG., May 17, 2009, at 47, 50 (“The paperwork was so confusing that I was never exactly sure who was paying what. I hazily understood that I was paying most of the fees, one way or another, but I couldn’t figure out how, and I couldn’t see any better alternatives.”).

<sup>54</sup> The number of closings reported probably understates the actual number. Brokers who did not initially answer the question were prompted “More than 100? More than 1000?” Probably some stated that they had attended more than 1,000, say, even though the number may have been much larger.

During the pre-survey research stage, I spoke to a mortgage broker who reported attending more than 50,000 closings [hereinafter, the 50,000 closing broker]. Because that broker was not called as part of the survey, and was asked slightly different questions from those posed in the survey, the broker’s responses are not included in the survey response, but are referred to in the footnotes when they are relevant.

<sup>55</sup> Only one broker reported encountering customers who withdrew from the closing and did not later proceed with the loan. The 50,000 closing broker shared the view that borrowers did not use the TILA disclosure forms for comparison-shopping. These findings are consistent with the report of ICF Macro of the findings it drew from its focus groups:

Even among participants who shopped for mortgages, the shopping process almost always ended at the point of loan application. . . . [O]nce a loan application was completed and accepted, very few participants ever revisited the shopping process and talked to other lenders—even after they learned that the loan they had been offered had terms they did not like, or that the terms of the offer had changed. . . .

. . . .

. . . The most frequent reason mentioned [for not withdrawing despite reservations] was that they did not feel they had any options at that point in time—particularly in the case of home purchase loans. In other cases, participants accepted loans because they believed, or were advised by lenders, that they could easily refinance to better terms in the near future. Finally, several participants said they felt intimidated and rushed during the closing process and as a result found it difficult to object or raise questions.

At the time of the survey, the only binding TILA disclosures were provided at the closing.<sup>56</sup> In other words, reading or hearing the only disclosures provided to consumers that contained their final loan terms did not ever prompt consumers to back out of their loans—no matter what the terms were.<sup>57</sup> Assuming that the experiences of these brokers were typical—which may not have been true, including for reasons discussed below—it seems clear that whatever benefit the disclosures conferred upon consumers, they did not help consumers to recognize and withdraw from loans on which they would later default.<sup>58</sup>

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ICF MACRO REPORT, *supra* note 33, at iii–iv.

<sup>56</sup> Effective July 30, 2009, lenders were obliged to furnish final disclosures no later than three days before the closing if the final disclosures differed materially from the good faith estimates. *See* Truth in Lending, 74 Fed. Reg. 23,289 (May 19, 2009) (to be codified at 12 C.F.R. pt. 226) (amending 12 C.F.R. § 226.19).

<sup>57</sup> *See also* Truth in Lending, 73 Fed. Reg. 44,542 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (“Borrowers who consider the disclosure may nonetheless feel constrained to close the loan, for a number of reasons. They may already have paid substantial fees and expect that more applications would require more fees. They may have signed agreements to purchase a new house and sell the current house. Or they may need to escape an overly burdensome payment on a current loan, or urgently need the cash that the loan will provide for a household emergency. . . . Furthermore, many consumers in the subprime market will accept loans knowing they may have difficulty affording the payments because they reasonably believe a more affordable loan will not be available to them. . . . [L]imited transparency of prices, products, and originator incentives reduces a borrower’s expected benefit from shopping further for a better option. Moreover, taking more time to shop can be costly, especially for the borrower in a financial pinch. Thus, borrowers often make a reasoned decision to accept unfavorable terms.”).

<sup>58</sup> One broker who responded to the survey indicated that some borrowers had rescinded loans after the closing, but not because of the TILA disclosures. A flaw in the study was that it did not expressly ask about post-closing rescissions. Some borrowers would have had a right to rescind under 12 C.F.R. § 226.23(a)(1) (2010), which gives borrowers a three-day right of rescission “[i]n a credit transaction in which a security interest is or will be retained or acquired in a consumer’s principal dwelling . . . .” The regulation excepts from this right certain refinancings as well as residential mortgage transactions, defined as the mortgage used to acquire or construct the home. 12 C.F.R. §§ 226.23(f)(1)–(2), 226.2(24) (2010). Thus, borrowers in some unknown number of the loans would have had a right to rescind, but other borrowers would not have this right. Consequently, it is possible that some borrowers completed the closing but rescinded within the three-day cooling off period, because of the TILA disclosures. This possibility seems unlikely, however, for several reasons. First, brokers might well have volunteered information about rescissions had they occurred, as one broker did; the fact that other brokers did not suggests that they were not aware of such rescissions. Second, consumers rescinding after the closing face the extra burden of “unwinding” the transaction, and so it would be more likely that someone with reservations would withdraw from the closing

The survey is less helpful in explaining why consumers fail to use the disclosures for the purpose of deciding whether the loan is suitable, though it is possible to speculate. First, it is possible that the brokers who responded to our questions were not typical of brokers generally, and in particular did not include many brokers that originated the loans that later defaulted. For every broker who answered our survey, nearly four declined.<sup>59</sup> It makes intuitive sense that brokers conscientious enough to answer survey questions would also be scrupulous enough to avoid originating loans that carried a high risk of default, and that brokers who would originate such loans would not trouble themselves to answer survey questions from which they would derive no great benefit. Conceivably, less altruistic brokers might not answer our questions, might be less meticulous in dealing with their borrowers, and might have some borrowers who withdraw upon seeing the disclosures at the closing.

Second, though the survey was not designed to ask how many of the borrowers were familiar with the disclosures before the closing, many of the survey respondents volunteered that borrowers were already familiar with the loan terms. Obviously, borrowers who knew the terms before coming to the closing would not be surprised to learn the terms at the closing, and so could not be expected to pull out at that point. It is possible to infer from these reports that some brokers kept their borrowers apprised of the loan terms, again suggesting a level of care that exceeds that of some other brokers. Borrowers who took out purchase mortgage loans or loans to construct homes may also have learned of the loan terms from the required good faith estimates;<sup>60</sup> to the extent that the estimated disclosures did not change before the closing—which can be true if a borrower “locks in” a rate—the borrower will learn the final terms from the good faith estimates. But there is also reason to believe that many customers were not familiar with the TILA disclosures before the closing. Some brokers noted that final terms sometimes do deviate from the estimated terms.<sup>61</sup> Significantly, many

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than rescind later. Third, consumers often experience the “endowment effect,” see *infra* note 173 and accompanying text, and so face some psychological barriers to rescinding. But it at least remains a theoretical possibility that some consumers did go through the closing and later rescinded.

<sup>59</sup> Because of a communication glitch, the number of brokers called was not recorded until fourteen brokers had already been surveyed. To obtain the remaining eighty-eight respondents, 390 were called, for a response rate of 22.6%.

<sup>60</sup> At the time the survey was conducted, originators were not required to supply consumers applying for refinancings with good faith estimates. The regulations have since been amended, as discussed *supra* note 28.

<sup>61</sup> See also *Public Hearing Before the Fed. Reserve Bd.: Building Sustainable Homeownership: Responsible Lending and Informed Consumer Choice* 135 (hearing

brokers reported that borrowers often asked at the closing why the Annual Percentage Rate (APR) disclosure was higher than the stated interest rate. Many consumers apparently feared that they were being charged a higher interest rate than they had expected.<sup>62</sup> Presumably, borrowers familiar with the TILA APR disclosure from an earlier disclosure—or even from reading the good faith estimate—would have asked that question when they first encountered the APR and so would not need to ask it at the closing. Another frequent source of questions at the closing was the “Total of Payments” disclosure, which informs borrowers how much they will pay over the life of the loan in interest and principal. This disclosure seemed to inspire a sort of sticker shock; again, borrowers who were already familiar with the disclosures should not have experienced shock at seeing the disclosures at the closing.

Of course, borrowers may fail to use the disclosures for reasons that have nothing to do with the brokers. They may already be committed, psychologically or otherwise, to the loan by the time they see the disclosures,

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before Fed. Reserve Bank of Philadelphia) (2006) [hereinafter *Philadelphia Public Hearing*] (statement of Jack M. Guttentag, University of Pennsylvania Wharton School of Business), available at <http://www.federalreserve.gov/events/publichearings/hoepa/2006/20060609/transcript.pdf> (“[T]he prices in this market are volatile. They change every day.”); *Atlanta Public Hearing*, *supra* note 10, at 155 (statement of Patricia McCoy, University of Connecticut School of Law) (“[I]n actual cases that I’ve looked at, the prices on subprime loans often turned out to be a moving target. A lender or broker might have the customer apply for one type of loan, price A, say a fixed rate loan; changed the loan during underwriting to an adjustable rate mortgage, price B; and then finally change the loan at closing to something different at price C, say an interest only mortgage.”); Bob Tedeschi, *New Law May Cause Delays*, N.Y. TIMES, Aug. 16, 2009, at RE10 (“Borrowers can see their interest rates change from the initially quoted rate for many reasons. If their credit score was lower than they first thought, or if they are required to pay mortgage insurance on the loan because their down payment money ran low, for instance, the rate can easily rise by more than one-eighth of a point.”).

For illustrations of how quickly mortgage rates change, visit THE MORTGAGE PROFESSOR’S WEBSITE, [www.mtgprofessor.com](http://www.mtgprofessor.com) (last visited Sept. 10, 2010).

<sup>62</sup> Cf. ICF MACRO REPORT, *supra* note 33, at iv, v, 11 (“Several [participants in focus groups and interviews] were confused by the fact that the interest rate was not included on the current TILA statement, or incorrectly assumed that the [APR] was the interest rate. . . . The meaning of the APR was generally not understood by participants. Almost all either assumed that this rate was the same as their interest rate, or understood that the two terms were different but could not explain how. . . . Participants had various misinterpretations of the APR, such as that it reflected how the rate would adjust in the future, or that it was the maximum possible rate.”).

and so it is possible that nothing could make them pull out of the loan at that point.<sup>63</sup>

Many of the brokers reported that they explained the disclosures to their borrowers at the closing. This, again, suggests that the respondents were more conscientious than some. Though the survey was not designed to find out why brokers engaged in this behavior, it is possible to speculate. As already noted, our respondents may simply have been biased towards more meticulous brokers. But other explanations are possible. Some brokers stated that they explained the disclosures because they were required to do so by law, and so they thought they had no choice in the matter. In fact, federal law does not so require.<sup>64</sup> Some brokers reported that it was their firm's policy to explain the disclosures, though of course that raises the question of why the firms require such an explanation. A cynical explanation might be that because consumers never withdraw from the closing after hearing the disclosures, the brokers have nothing to lose (besides time) in walking borrowers through the disclosures. An even more cynical explanation is that by talking borrowers through the forms, the broker can spin the information contained therein in a way to keep the borrower from withdrawing. For example, to ameliorate the perceived sticker shock, brokers can point out the Total of Payments disclosure, and then observe that it is relevant only to those who intend to stay in their homes without refinancing for the full mortgage term—often thirty years—something that few borrowers may expect to do. Another possibility is that brokers have learned that borrowers inquire about the difference between the APR and the interest rate if they are not told, and they wish to forestall such questions.

The survey also asked what percentage of consumers spent more than a minute reading the TILA disclosures. As it became clear that many brokers explained the disclosure to their customers, this question was broadened to cover the situation in which the customer spent more than a minute with the disclosures, either because the broker explained them for that period of time, or because the borrower read them, or both. Of the 102 brokers surveyed, fifty-three, or just over half, reported that less than 10% of their borrowers spent more than a minute with the disclosures. An additional twenty stated

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<sup>63</sup> See Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 352 (2005) (stating that on the day of the loan closing “a borrower has psychologically committed herself to the loan”). As discussed *infra* note 177 and in the accompanying text, Congress has moved the disclosure date forward to three days before the closing takes place.

<sup>64</sup> Cf. Truth in Lending, 74 Fed. Reg. 23,289 (May 19, 2009) (to be codified at 12 C.F.R. pt. 226) (requiring creditors “to make good faith estimates of the required mortgage disclosures” and to either deliver these estimates or place them in the mail, but nowhere requiring the creditor to explain the disclosures to the borrower).

that between 10 and 29% of their customers devoted more than a minute to the disclosures, meaning that more than two-thirds of the brokers reported that less than 30% of their borrowers spent more than a minute with the disclosures.<sup>65</sup>

A minute to understand the disclosures—and it may be less than that<sup>66</sup>—does not seem like very much time considering that mortgages are typically the largest and longest-term obligation a consumer ever assumes.<sup>67</sup> Because consumers rarely shop for mortgages, they typically lack the experience needed to make sense of loan terms.<sup>68</sup> And mortgage terms are complex. That is, after all, the reason Congress enacted TILA in the first place. For example, Oren Bar-Gill has noted that option ARMs offer four different

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<sup>65</sup> This is consistent with the Fed's comment that, "At the closing table, many borrowers may not notice the disclosure of the payment amount or have time to consider it because borrowers are typically provided with many documents to sign then." Truth in Lending, 73 Fed. Reg. 44,542 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226). The 50,000 closing broker, *see supra* note 54, reported that 90% of the time borrowers spend far less than a minute on the TILA disclosures, and that half spend less than thirty seconds on the form.

<sup>66</sup> Compare the results reported in the text with GOLDSTEIN, *supra* note 47, at 16 ("Borrowers report that their loan settlements occurred at their kitchen tables and took little more than a few minutes.").

<sup>67</sup> *See also* ICF MACRO REPORT, *supra* note 33, at iv, 10 ("Many [participants in focus groups and interviews] commented that because they were shown so many papers at closing they did not read any of them carefully—including their TILA and HUD-1 statements. . . . Participants who did recognize the TILA statement were asked whether they had found the document useful when they received it previously. Most indicated that they had not, either because they had not understood it or because they had not paid attention to it at loan closing.").

<sup>68</sup> *See Philadelphia Public Hearing*, *supra* note 61, at 164–65 (2006) (statement of Loretta Abrams, Vice President of Consumer Affairs, HSBC North America). Ms. Abrams noted that an HSBC survey had found the following:

78 percent of consumers, stated that they are not, at all, very knowledgeable about how to take out a mortgage loan, they actually spend very little time reviewing mortgage options. . . . 34 percent of consumers told us that they researched their mortgage options for less than a week, and people spend months looking for just the right home, and then they spend less than a week making sure they've got just the right mortgage . . . .

*Id.*; *see also* Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1128 (2009); REN S. ESSENE & WILLIAM APGAR, JOINT CTR. FOR HOUS. STUD. OF HARVARD UNIV., UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 11 (Apr. 25, 2007), available at [http://www.jchs.harvard.edu/publications/finance/mm07-1\\_mortgage\\_market\\_behavior.pdf](http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf).



options for each monthly payment—and that’s only one loan term.<sup>69</sup> Or imagine how much time would be needed to explain to a borrower the 2/28 mortgage payment term quoted above. It seems improbable that consumers unfamiliar with such transactions could comprehend the consequences of such terms based on an explanation of a minute or less. Moreover, borrowers may not focus on those terms at all. Instead, as already noted, it appears that many brokers and customers devoted their time to discussing the discrepancy between the APR and the interest rate, and the Total of Payments disclosure, which merit attention, but are not the only disclosures that borrowers should attend to.<sup>70</sup>

When combined with the erroneous disclosures, the survey produces ironic results. It may not matter that the forms are misleading, because few borrowers attend to them. And it may not matter that few borrowers attend to them, because the forms are misleading. Indeed, because borrowers cannot be misled by forms they ignore, borrowers who spend little time with their TILA disclosure forms may be better off than those who studied them closely. And perhaps the cruelest irony is that the resources poured into fashioning and providing the forms to borrowers for decades appear to have

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<sup>69</sup> Bar-Gill, *supra* note 68, at 1103. Bar-Gill continues:

[T]hese payment options are not predetermined sums; nontrivial calculations are necessary to figure out what the options are. Moreover, these contracts, while allowing negative amortization, typically cap the level of permissible negative amortization, recasting the loan—even before the end of the introductory period—if this cap is reached.

*Id.*

In *O'Donnell v. Bank of America*, the court described an option ARM in the following terms:

The loan product has an initial low teaser interest rate with correspondingly low initial payments. The interest begins to adjust approximately one month into the loan. While the interest rates are adjusting on the loan, the scheduled payments, which are set to correspond with the initial rate, are subject to a 7.5% annual increase until the loan reaches a “Reamortization Date.”

*O'Donnell v. Bank of Am.*, No. C-07-04500 RMW, 2009 WL 765670, at \*1 (N.D. Cal. Mar. 20, 2009) (citations omitted).

<sup>70</sup> The brokers’ reports are consistent with surveys reported in Durkin & Elliehausen, *supra* note 17, at 129. Those surveys conducted in 1977 (in that year, the Survey of Consumer Finances), 1981 (in that and later years, the Survey of Consumers), 1994, and 1997, showed that, depending on the year, 27 to 34% of consumers strongly disagreed with the statement that “Most People Read Their Truth-in-Lending Statements Carefully,” while 33 to 38% disagree somewhat with that statement. *Id.* at 123, 129; see also ESSENE & APGAR, *supra* note 68, at 45 (claiming that disclosure documents are often signed without being understood).

been largely wasted, and even worse than wasted, because it created the illusion of consumer protection—just as it created the illusion of accurate disclosures—where none existed.

In sum, it appears that TILA failed to help the subprime borrowers understand the terms of the loans they were entering into at a useful time, and the consequences those terms would have for them. This can be inferred first, from the misleading nature of the forms themselves, and second, from two of the survey responses: (1) that many borrowers spent so little time with the disclosures despite their complexity; and (2) that borrowers never withdrew from loans at the closing, even though many seemingly saw the final TILA disclosures for the first time at the closing—and learned for the first time at the closing what those forms said their loan terms would be. It seems inconceivable that nearly every consumer, upon learning the final loan terms for the first time, concluded that they were satisfactory.

It is tempting to blame the borrowers themselves for their behavior. They could, after all, withdraw from loans with unfortunate terms, and they could insist on taking more time with the disclosures. The loans on which consumers defaulted were all consensual transactions. But when we know that borrowers behave in predictable ways that are not in their best interests, are not in society's best interests, and that, as discussed below, unscrupulous lenders take advantage of, blaming consumers as an excuse for not changing the rules governing the transactions only permits the undesirable behavior to continue.<sup>71</sup> A better approach would find ways to forestall the undesirable behavior while minimizing the costs of doing so. Part III discusses some ways to accomplish that goal. But first, Part II continues exploring the reasons why consumers may act unwisely.

#### *D. Other Evidence that TILA Failed*

Many have noted that consumers entered into loans without understanding their terms.<sup>72</sup> Thus a survey of various parties involved in

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<sup>71</sup> Indeed, if so many consumers are giving the disclosures too little attention to make appropriate decisions, it could be argued that the reasonable consumer so behaves.

<sup>72</sup> See generally *State of the U.S. Economy and Implications for the Federal Budget: Hearing Before the H. Comm. on the Budget*, 110th Cong. 13 (2007) (statement of Peter Orszag, Congressional Budget Office Budget Director) ("The rise in defaults of subprime mortgages may also reflect the fact that some borrowers lacked a complete understanding of the complex terms of their mortgages and assumed mortgages that they would have trouble repaying." (footnote omitted)); President's News Conference, 43 WEEKLY COMP. PRES. DOC. 1060 (Aug. 9, 2007) ("We've had a lot of really hardworking Americans sign up for loans, and the truth of the matter is they probably didn't fully understand what they were signing up for."); Truth in Lending, 73 Fed. Reg. 44,525–26 (July 30, 2008) (to be

predatory lending in Philadelphia reported “settlement agents will readily admit that borrowers, although signing numerous documents, generally have no idea at all what they are getting into.”<sup>73</sup>

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codified at 12 C.F.R. pt. 226) (“Consumers who do not fully understand such terms and features, however, are less able to appreciate their risks, which can be significant. For example, the payment may increase sharply and a prepayment penalty may hinder the consumer from refinancing to avoid the payment increase. Thus, consumers may unwittingly accept loans that they will have difficulty repaying.”); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1286 (2002) (“[T]he victims of predatory lenders sign documents without having a clear sense of the terms of the contracts, how much they borrowed, what they purchased, the terms of repayment, or the risks they assumed.”); Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing But the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 196 (2008) (“The lender-created complexity of mortgage loans now exceeds what most consumers, even highly educated consumers, are capable of comprehending.”); Zywicki & Adamson, *supra* note 2, at 73 (“Mortgages, whether in the prime or subprime market, are inherently complex products about which a consumer knows and can know little. First-time homebuyers are generally overwhelmed at the complexity and amount of loan documentation that accompanies a home purchase and the[ir] lack of opportunity to fully read and ask questions about [their] mortgage terms. Having gone through the experience once, second-time homebuyers rarely closely examine their loan documents. Nor is it likely, even if they did take the time to examine their documents, as we have seen, that average borrowers would be able to comprehend most of their terms.”); BARR ET AL., *supra* note 48, at 8 (“While the causes of the mortgage crisis are myriad, a central problem was that many borrowers took out loans that they did not understand and could not afford.”); ALLEN J. FISHBEIN & PATRICK WOODALL, CONSUMER FED’N OF AM., EXOTIC OR TOXIC? AN EXAMINATION OF THE NON-TRADITIONAL MORTGAGE MARKET FOR CONSUMERS AND LENDERS 20 (May 2006), available at [http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/Exotic\\_Toxic\\_Mortgage\\_Report0506.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/Exotic_Toxic_Mortgage_Report0506.pdf) (“[M]ore vulnerable consumers—first time homebuyers, unsophisticated financial consumers, and consumers traditionally underserved by the mortgage market, especially lower-income and minority consumers . . . are less likely to understand . . . the complexity of the mortgage vehicles they are offered . . .”). Mortgage industry insiders also acknowledge the point. See, e.g., *Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing Before the Subcomm. on Hous., Transp. & Cmty. Dev. of the S. Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 112 (2007) (testimony of Denise Leonard, Director, National Association of Mortgage Brokers) (“Current disclosures have failed to keep pace with market innovations. Consumers are not being given the tools needed to effectively shop for a mortgage in a market that is offering increasingly innovative and complex options.”); *Atlanta Public Hearing*, *supra* note 10, at 92 (statement of Ken Logan, Chairman-Elect, National Home Equity Mortgage Association) (“[F]ew borrowers fully understand their residential transaction or the disclosures.”); BITNER, *supra* note 44, at 133 (former mortgage lender estimated that half of mortgage borrowers did not understand “what they were doing”).

<sup>73</sup> GOLDSTEIN, *supra* note 47, at 16. The study also states: “[I]f the borrowers had access to full, complete and accurate information, they would never have entered into the

Such claims also find support in evidence that some borrowers pay more than other similarly-situated borrowers, which implies a market failure. Thus, one study concluded that “younger adults and older adults borrow at higher interest rates and pay more fees than middle-aged adults controlling for all observable characteristics . . . .”<sup>74</sup> Similarly, another study found that “borrowers with a bachelor’s degree pay their brokers \$1,500 less than those without, other things equal.”<sup>75</sup> Perhaps the most dramatic instance of this effect comes from the ability of lenders to steer borrowers who could have qualified for prime loans to higher-cost subprime loans.<sup>76</sup> Thus, Wells Fargo

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transactions. Interviews with borrowers, lenders, attorneys representing both lenders and borrowers and settlement agents reveal that a lack of information is a crucial aspect of the transactions.” *Id.* at 15–16.

<sup>74</sup> Sumit Agarwal et al., *The Age of Reason: Financial Decisions Over the Life-Cycle with Implications for Regulation* 3, 22, 23 (Oct. 19, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=973790> (“[F]or home-equity lines of credit, 75-year olds pay about \$265 more each year than 50-year olds, and 25-year olds pay about \$295 more. . . . [M]iddle-aged adults borrow at lower interest rates and pay fewer fees relative to younger and older adults. . . . The measured effects are not explained by . . . age-dependent default risks.”); see also *id.* at 71, 74 (figures demonstrating that the middle-aged borrowers in the authors’ study had lower (worse) FICO scores and higher default rates than the younger and older adults in the study).

<sup>75</sup> Susan E. Woodward, *Consumer Confusion in the Mortgage Market* 1 (unpublished manuscript) (July 14, 2003) [hereinafter Woodward, *Consumer Confusion*], available at [www.sandhillecon.com/pdf/consumer\\_confusion.pdf](http://www.sandhillecon.com/pdf/consumer_confusion.pdf). The author also found that the borrower’s race and broker’s sex affect the broker’s fee. *Id.* at 2; see also SUSAN WOODWARD, *A STUDY OF CLOSING COSTS FOR FHA MORTGAGES* ix, xiii (May 2008) (report prepared for U.S. Dep’t of Hous. & Urban Dev. Office of Pol’y Dev. & Research) [hereinafter WOODWARD, *STUDY OF CLOSING COSTS*], available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1341045](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1341045) (“African-American borrowers pay an additional \$415 for their loans after accounting for other borrower differences and Latino borrowers pay an additional \$365, on average. . . . On average, borrowers who completed college are charged \$1100 less than borrowers who did not go to college at all, other things equal. . . . These variations suggest that markets are not fully transparent or competitive.”).

<sup>76</sup> See *Atlanta Public Hearing*, *supra* note 10, at 37 (statement of Margot Saunders, National Consumer Law Center) (“[T]he high price is obtained from borrowers from whom they can be obtained from [sic] and the losses that result from those loans are used as the justification for the high price. I have seen dozens and dozens of loans with very high prices made to people who had very high credit ratings. I think those people were just more vulnerable.”); ILL. DEP’T FIN. AND PROF’L REGULATION, *supra* note 10, at 5 (study of Chicago borrowers finds that many of the borrowers could have qualified for “a more affordable loan had they been better informed about what was available to them”); Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 556 (2005); Marsha J. Courchane et al., *Subprime Borrowers: Mortgage Transitions and Outcomes*, 29 J. REAL ESTATE FIN. & ECON. 365,

loan officers have reported in affidavits filed in a case brought by the City of Baltimore against Wells Fargo that they persuaded loan applicants to settle for subprime loans even though the applicants could have obtained lower-cost loans.<sup>77</sup> Wells Fargo's representatives were able to do so by telling applicants, for example, that the subprime loans required less paperwork or could be processed more quickly. Given the substantially greater costs of subprime loans, which can amount to many thousands of dollars in higher interest payments, such strategies could work only in a dysfunctional market.<sup>78</sup> To see why this is so, imagine a grocery store that attempted to persuade consumers to purchase milk at \$30 a quart by promising reduced paperwork or faster service. Such a store would not sell much milk. But in a market in which consumers do not comparison-shop with the actual terms, such as our survey indicates is true of the home lending market, consumers are not able to discover that they can obtain financing at lower cost.<sup>79</sup>

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381 (2004) ("Our results suggest that borrowers may inappropriately receive subprime mortgages . . ."); Morgenson, *supra* note 12, at 9 (Countrywide's "incentive system also encouraged brokers and sales representatives to move borrowers into the subprime category, even if their financial position meant that they belonged higher up the loan spectrum."); cf. Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POLICY DEBATE 533, 566 (2004) ("More than two-fifths of subprime borrowers do not think they got the mortgage that was best for them, nearly nine times more than prime borrowers who express this kind of discontent.").

<sup>77</sup> Declaration of Elizabeth M. Jacobson, Brief of Plaintiff Exhibit 2 at 3–4, City of Balt. v. Wells Fargo, N.A., 677 F. Supp. 2d 847 (D. Md. 2010) (No. 1:08 CV 62) [hereinafter Jacobson Aff.]; see also Declaration of Tony Paschal, Brief of Plaintiff Exhibit 1 at 6, City of Balt. v. Wells Fargo, N.A., 677 F. Supp. 2d 847 (D. Md. 2010) (No. 1:08 CV 62) [hereinafter Paschal Aff.] ("I . . . regularly saw minority customers who had good credit scores and credit characteristics in subprime loans who should have qualified for prime or [Fair Housing Act] loans.").

<sup>78</sup> See EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 19 (2007) ("[I]t is complicated and confusing for borrowers to search out all their available options, to understand all the terms of the loans, and to avoid getting misallocated into a lower credit category than may be appropriate. In the end the process by which rates are set is regulated by the borrower's ability to shop around, and prospective borrowers may not know where to shop, what to ask, or how to evaluate their own credit-worthiness." (citation omitted)).

<sup>79</sup> Confusion about loan terms may also contribute to defaults. For example, the added costs incurred by borrowers who end up with more expensive loans than they might have qualified for may tip the loan over into being unaffordable, with the result that the borrower defaults even though the borrower might have been able to meet her payment obligations on a more appropriate loan. See *Atlanta Public Hearing*, *supra* note 10, at 15 (statement of Margot Saunders, National Consumer Law Center) ("The price too often creates the risk."); see also LACKO & PAPPALARDO, *supra* note 47, at 123 ("Consumers who do not recognize key loan costs can be harmed in a number of ways. They may be unable to fully understand the cost of their loan, assess whether it is a good

Still other evidence that consumers have not made wise decisions is found in the number of borrowers who seem to have entered into loans inappropriate for their situation.<sup>80</sup> The federal Department of Housing and Urban Development takes the position that a household's housing is unaffordable if housing costs consume more than 30% of the household income; housing is considered severely unaffordable if the housing absorbs more than half the household's income.<sup>81</sup> By that standard, in 2006, nearly a third of U.S. households could not afford their housing, and more than a tenth had severely unaffordable housing.<sup>82</sup> It seems unlikely that so many families assumed such obligations fully understanding the consequences, but

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deal, ensure that the terms are appropriate to their circumstances, and compare loan offers from different lenders. These consumers may pay more for their loans than necessary by unknowingly accepting excessive settlement costs or charges for unwanted optional products. . . . They may obtain loan terms that are inappropriate to their circumstances, such as unknowingly accepting a prepayment penalty when they know they are likely to refinance soon. And they may make inappropriate trade-offs between long- and short-term costs (that is, between interest rates and points) or inappropriate selections of alternative mortgage products (such as interest-only or payment option loans).").

<sup>80</sup> See GOLDSTEIN, *supra* note 47, at 68 ("What becomes clear in the course of interviews with borrowers and industry people alike is that consumers often end up with products that are not appropriate to their given circumstance. Either they do not understand the product or do not have the financial wherewithal to deal with the mortgage as its various features unfold over time.").

<sup>81</sup> OFFICE OF POL'Y DEV. AND RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING 1978-1999: A REPORT TO CONGRESS ON WORST CASE HOUSING NEEDS 11 (2003), available at <http://www.huduser.org/publications/PDF/trends.pdf>; *Glossary of Terms to Affordable Housing*, U.S. DEP'T OF HOUS. & URBAN DEV., <http://www.hud.gov/local/nv/library/archives/features/2006-04-06glos.cfm> (last visited Aug. 23, 2010); DANILO PELLETIERE ET AL., NAT'L LOW INCOME HOUS. COAL., WHO'S BEARING THE BURDEN? SEVERELY UNAFFORDABLE HOUSING: AN EXAMINATION OF NATIONAL AND STATE AFFORDABLE HOUSING NEEDS FROM THE 2003 AMERICAN COMMUNITY SURVEY (Aug. 2005), available at <http://www.nlihc.org/doc/bearingburden.pdf>; see also Daniel A. Mica, *Financial Literacy—Yeah, Gimme Some of That*, CREDIT UNION MAG., Jan. 2008, at 2A, 2A ("The . . . counselor's rule of thumb has long been that a consumer risks serious trouble when total housing expense reaches 30% of gross income.").

<sup>82</sup> JOINT CTR. FOR HOUS. STUD. OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2008 40 (2008), available at <http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf>; see also Mica, *supra* note 81, at 2A ("[M]ore than one-third of U.S. homeowners spend [30%] or more [of their gross income] on housing. Worse, one of seven homeowners spends 50% or more of pre-tax income on shelter.").

then, our survey and the TILA forms themselves raise doubts about whether they did.<sup>83</sup>

Similarly, as Oren Bar-Gill has observed, loans which provide for a low initial interest rate followed by higher rates are designed for those who have reason to expect a dramatic jump in their incomes, such as students who can anticipate a lucrative career upon graduation. Yet the millions of borrowers who took out such loans surely exceed the number of people who fit that description.<sup>84</sup>

Additional evidence that borrowers did not understand their payment obligations and their consequences can be found in the number of borrowers who defaulted quickly on those obligations. Thus, studies have found that “the age of subprime loans at foreclosure[] is generally 2 years or less . . . .”<sup>85</sup> At one prominent subprime lender, New Century Financial, the percentage of borrowers who missed one of the first three payments hit 10% in the third quarter of 2004 and rose as high as 16% in 2006.<sup>86</sup> While some early defaulters may have been crooks who never intended to repay loans, and others speculators, and still others unfortunates who encountered a run of bad luck, others seemingly did not understand their obligations or overestimated their abilities to meet those obligations.<sup>87</sup>

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<sup>83</sup> Probably some of these borrowers suffered financial reversals which reduced their income, thereby placing them in these categories, but it is unlikely that most of them did.

<sup>84</sup> Bar-Gill, *supra* note 68, at 1109.

<sup>85</sup> HAROLD L. BUNCE ET AL., U.S. DEP’T OF HOUS. AND URBAN DEV., SUBPRIME FORECLOSURES: THE SMOKING GUN OF PREDATORY LENDING? 257, 268 (2001), available at <http://www.huduser.org/publications/pdf/brd/12bunce.pdf>; see also Mayer et al., *supra* note 21, at 37.

<sup>86</sup> DAN IMMERGLUCK, FORECLOSED: HIGH-RISK LENDING, DEREGULATION, AND THE UNDERMINING OF AMERICA’S MORTGAGE MARKET 128–29 (2009).

<sup>87</sup> While this finding, to some extent, undermines the significance of the misleading nature of the TILA disclosures for 2/28 loans, because changes in the monthly payments were less significant to borrowers who defaulted before reaching the first change date, it does not render it without importance for several reasons. First, some borrowers did not default until after the first change date. See Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 21–22, 34 (Fed. Reserve Bank of St. Louis, Research Div., Working Paper No. 2006-042A, 2006), available at <http://research.stlouisfed.org/wp/2006/2006-042.pdf>. Second, the 2/28 mortgage was only one type of loan. Other loans provided for adjustment much earlier than the second year, and so borrowers with such loans may have defaulted precisely because of unexpected payment increases. See Press Release, Freddie Mac, Freddie Mac Releases Results of Its 23rd Annual ARM Survey (Jan. 3, 2007), available at [http://www.freddie-mac.com/news/archives/rates/2007/20070103\\_06armsurvey.html](http://www.freddie-mac.com/news/archives/rates/2007/20070103_06armsurvey.html). Third, even some of those who defaulted before their payments increased might have been dissuaded from taking out the loans if the disclosure forms had conveyed to them the amounts to which their monthly payments could have risen, thereby helping them to

### E. *Why has TILA Failed?*

Why have the TILA disclosures been so unhelpful? Some causes of the problem may be structural. TILA, in common with many disclosure statutes, suffers from mandating a communication that the sender—the originator—often does not have an interest in being received, and, in the case of unscrupulous originators, may have an interest in obscuring or spinning in a particular way, a point amplified upon below. Lenders who plan to retain the loan have a stake in the borrower understanding the loan terms if the borrower will first, prove unable to make the payments at some point, and second, would so realize upon understanding the loan terms. But if the lender plans both to make and retain the loan, the lender must expect that the borrower will be able to make the loan payments. Consequently, the lender may believe that it has little to gain if the borrower fully appreciates the loan terms—especially since if the lender thinks the borrower can make the loan terms, but the borrower withdraws from the closing anyway, the lender has lost a sale. Originators who plan to sell loans to others have even less of a stake in borrowers understanding loan terms. Because they will not retain the loan, they do not bear the risk of a default. If the borrower pulls out of the loan, such an originator loses a sale and has no offsetting reduction in risk. Such an originator has nothing to gain by the borrower withdrawing from the loan and much to lose. In short, often the people who must present the disclosures may not perceive that they have anything to gain if borrowers understand them. As a result, unscrupulous originators lack an interest in eliminating distractions, providing clarifications, or learning from experience how to improve the communication or fix the disclosures. Instead, that role is left to government officials. But government suffers from inherent disabilities in playing that role.

The TILA disclosures are partly dictated by Congress, through TILA itself, and partly by the Federal Reserve Bank, which implements TILA through Regulation Z and the accompanying Commentary (though the Federal Reserve's responsibility is to be shifted to the Consumer Financial

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better understand the risk they were taking. Put differently, some borrowers upon seeing their possible exposure once the monthly payments could shift, might have turned down the loan, and so not have defaulted. Fourth, many borrowers continued making payments after their monthly payments leaped to unexpected amounts, but those higher payments may have placed great stress on their household budgets, and some may default in time. See Mayer et al., *supra* note 21, at 37 (“Mortgage rate resets may yet cause difficulties going forward: households trying to refinance hybrid short-term mortgages in 2008 and later face an environment of stagnant to falling house prices and tightened underwriting standards.”).



Protection Bureau).<sup>88</sup> This two-headed arrangement has made the drafting of effective disclosures difficult. Members of Congress have so many concerns besides TILA that they can only rarely afford TILA the attention it requires, while the leaders of the Fed have been chosen not for their expertise in consumer protection, much less consumer disclosure regulation, but for their knowledge of macroeconomics (quite rightly, in light of the important role the Fed plays in managing the economy). It is, therefore, hardly surprising that the original version of former Fed Chair Alan Greenspan's memoir, *The Age of Turbulence*, almost completely overlooked TILA, while including entire chapters on each of China, Russia, and Latin America, areas of the world for which the Fed has no formal responsibility.<sup>89</sup> Thus, Oren Bar-Gill and Elizabeth Warren have commented that "The Federal Reserve does not view consumer protection as its core mission."<sup>90</sup> The result is that TILA has not received the attention it merits. That the Fed did not itself conduct a survey of the type described herein and took twenty years to propose changes in its misleading disclosures for adjustable-rate mortgages offers further support for that proposition. Such concerns contributed to Congress's decision to transfer the Federal Reserve's authority over TILA to the new CFPB.<sup>91</sup>

But TILA's failure cannot be attributed solely to the fact that it has been administered by an agency devoted to monetary policy. The effectiveness of disclosure itself has limits, as illustrated by a series of tests conducted by Macro International for the Federal Reserve Board in 2008.<sup>92</sup> Macro had consumers read disclosures stating that mortgage brokers had an incentive to arrange for loans with higher interest rates, because that would increase broker compensation.<sup>93</sup> Macro's report of its finding stated:

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<sup>88</sup> See *supra* note 25 and accompanying text.

<sup>89</sup> ALAN GREENSPAN, *THE AGE OF TURBULENCE* 294–310, 323–45 (2007).

<sup>90</sup> Bar-Gill & Warren, *supra* note 39, at 90 n.293; see also EDMUND ANDREWS, *BUSTED: LIFE INSIDE THE GREAT MORTGAGE MELTDOWN* 79 (2009) (reporting that Federal Reserve governors viewed the chairmanship of the Fed's consumer affairs committee as "a backwater"); Heidi Mandanis Schooner, *The Role of Central Banks in Bank Supervision in the United States and the United Kingdom*, 28 *BROOK. J. INT'L L.* 411, 427 (2003) ("[T]he Federal Reserve's . . . regulatory role remains focused on safety and soundness and not on other goals of financial regulation . . .").

<sup>91</sup> See Dodd-Frank Act §§ 2(3), 2(4), 1061(b)(1)(A), 124 Stat. 1387, 2036.

<sup>92</sup> MACRO INTERNATIONAL, INC., *CONSUMER TESTING OF MORTGAGE BROKER DISCLOSURES* i (July 10, 2008) (report submitted to Fed. Reserve Bd.) [hereinafter *MACRO INT'L*], available at <http://www.federalreserve.gov/newsevents/press/bcreg/20080714regzconstest.pdf>.

<sup>93</sup> *Id.* at 1.

Nearly all participants were surprised to read about the brokers' conflict. . . .

Shortly after reading the disclosure, about half of the participants made statements that directly contradicted what they had read in the agreement about broker incentives. Several, for example, stated late in their interviews that they would expect the broker to show them the loans with the best terms available. However, the disclosure they had just read specifically pointed out that brokers would in fact have incentives not to do so.<sup>94</sup>

So Macro disclosed the conflict more explicitly. The following paragraph describes the result:

As in [the earlier round], most participants understood upon their first reading of the agreement that the broker would have a financial incentive to provide them with higher-interest rate loans. Again, however, participants' preconceived belief that brokers were working in the best interest of borrowers made this conflict difficult to accept. As a result, many became confused or reverted to their prior assumptions.<sup>95</sup>

And, Macro found, the revised disclosures led to other misconceptions.<sup>96</sup> In short, even under perfect conditions, when no one is attempting to distract consumers from focusing on disclosures, deceive them, or rush them into a particular transaction, disclosures may not be useful to consumers when they create cognitive dissonance. As Fed Chairman Ben S. Bernanke has noted, "not even the best disclosures are always adequate. . . . [S]ome aspects of increasingly complex products simply cannot be adequately understood or evaluated by most consumers, not matter how clear the disclosure."<sup>97</sup>

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<sup>94</sup> *Id.* at 12. Others have noted that borrowers suffer from this misconception. *See, e.g.,* Truth in Lending, 73 Fed. Reg. 44,525 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) ("Anecdotal evidence indicates that consumers in both the prime and subprime markets often believe, in error, that a mortgage broker is obligated to find the consumer the best and most suitable loan terms available."); GOLDSTEIN, *supra* note 47, at 17 ("Borrowers say they believed, albeit incorrectly . . . that the broker they hired represented their best interests."); *cf.* WOODWARD, STUDY OF CLOSING COSTS, *supra* note 75, at 4 ("Mortgage brokers are like any other market seller of shoes or groceries who buys at wholesale and sells at retail. Their goal as profit maximizers is to find the cheapest wholesale terms and charge what the market will bear.").

<sup>95</sup> MACRO INT'L, *supra* note 92, at 22.

<sup>96</sup> *Id.* at 26.

<sup>97</sup> Ben S. Bernanke, Chairman, Fed. Reserve Bd., Address at the Federal Reserve System's Biennial Community Affairs Research Conference (Apr. 17, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>.

In addition, disclosures do not appear to be unique in failing to elicit consumer attention. Recent studies have tended to confirm the long-suspected intuition that often consumers merely skim contracts or do not read them at all—and of course such habits may carry over to how consumers treat mandated disclosures, including TILA disclosures.<sup>98</sup> Thus, one survey found that significant majorities of consumers reported that they did not read certain standard form contracts before agreeing to them.<sup>99</sup> As an April Fool's

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<sup>98</sup> See MACRO INTERNATIONAL INC., DESIGN AND TESTING OF EFFECTIVE TRUTH IN LENDING DISCLOSURES 6, 11 (May 16, 2007) (report submitted to Fed. Reserve Bd.) ("Participants indicated that they would be unlikely to read a change-in-terms insert that was included with their periodic statement, and would probably throw it away. . . . Participants paid very little attention to the [credit] cardholder agreement; only a few participants looked at it at all, and these only skimmed it briefly. When asked, a vast majority of participants indicated that they generally do not look at their cardholder agreements. Most participants indicated that the reasons they do not read their agreements are that the type size is very small and they find them difficult to understand."); Debra Pogrud Stark & Jessica M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 N.Y.U. J. L. & BUS. 617, 656–57 (2009) ("One reason why consumers might not read contracts is that the contract forms are often user-unfriendly. Font sizes are often very small, and the clauses within sentences can be very long, which can make it physically difficult and taxing for consumers to read. These user-unfriendly features increase fatigue, particularly among the elderly, stroke survivors, and anyone who is even moderately visually impaired. In addition, the long length of what the consumer is expected to read can cause consumers to decide to at most skim, rather than carefully read, the documents they sign." (footnotes omitted)).

<sup>99</sup> Shmuel I. Becher & Esther Unger-Aviram, *The Law of Standard Form Contracts: Misguided Intuitions and Suggestions for Reconstruction* 12 (unpublished manuscript) (Aug. 7, 2009), available at <http://ssrn.com/abstract=1443908>. The three contracts at issue were for a car rental, laundry services, and opening a bank account. See *id.* at 9. The exception, which does not seem analogous to mortgage loan papers, was for a nursery school placement. See *id.* Many consumers did claim, however, that they would skim the contracts before signing them. *Id.* at 12. Factors reported to most strongly influence the likelihood that a consumer would read a contract included the costs of the transaction, the possibility of changing or improving contract terms, and the length of the contract. *Id.* at 18; see also Stark & Choplin, *supra* note 98, at 694–95, 699–700 (22.9% of sample acknowledged not reading purchase agreement when buying home; 6.1% of those with mortgage admitted not having read any terms in loan documents; of those who reported reading loan documents, 77.4% stated they had not read all the terms; authors concluded the "self-reported level of the public reading all of the terms of their loan documents is highly unlikely to be accurate" and noted that a research assistant who had formerly been a mortgage broker took over three hours to read all the terms for a typical home loan; the percentage of consumers who reported they did not read all the terms in the following types of contracts appears after the type of contract on the following list: car rental contracts: 71%; packaged good terms: 89%; terms on downloading software: 95%; apartment rental agreement: 43%).

joke, a computer game company added to its online contract a provision granting the company the “immortal soul” of customers agreeing to the contract; 88% of its customers sold their souls even though they could have clicked on a “simple tick box” to opt out, which would also have brought them a five pound voucher.<sup>100</sup>

Other researchers tested whether consumers read disclosures by giving study participants a consent form described as follows:

The second paragraph was a long-winded explanation of informed consent, but buried three quarters of the way through this paragraph, was a sentence suggesting that participants should not sign this consent form as its terms were clearly not in their best interests. . . . Buried within the fifth paragraph. . . were clauses that. . . committed participants to administering electric shocks to fellow participants, if instructed to do so, even if that participant screamed, cried, and asked for medical assistance. It also required participants to do push-ups if the experimenter instructed them to do so.<sup>101</sup>

More than 95% of the participants signed the form, and most did so without even skimming it.<sup>102</sup> The experimenters then explained that the consent form had been a fake and asked participants to sign a genuine consent form.<sup>103</sup> More than a third of those who had signed the bogus form signed the actual consent form without reading it while only 21.8% read the entire form; the average time spent looking at the actual form was sixteen seconds.<sup>104</sup> The lesson for those designing disclosures seems clear: many consumers will not read forms even after learning that they have been deceived by failing to read such a form—and of course many of the subprime borrowers who later defaulted may have been deceived by their failure to read the TILA disclosure form.

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<sup>100</sup> See *7,500 Online Shoppers Unknowingly Sold Their Souls*, FOX NEWS, Apr. 15, 2000, <http://www.foxnews.com/scitech/2010/04/15/online-shoppers-unknowingly-sold-souls/>. The clause stated that the company:

[R]eserve[d] the right to serve . . . notice in 6 (six) foot high letters of fire, however we can accept no liability for any loss or damage caused by such an act. If you a) do not believe you have an immortal soul, b) have already given it to another party, or c) do not wish to grant Us such a license, please click the link below to nullify this sub-clause and proceed with your transaction.

*Id.*

<sup>101</sup> Stark & Choplin, *supra* note 98, at 679.

<sup>102</sup> *Id.* at 681.

<sup>103</sup> *Id.* at 680.

<sup>104</sup> *Id.* at 682.

The TILA disclosures also face other impediments at conveying loan terms, as discussed in the next subsection.<sup>105</sup>

#### F. Other Problems for Borrowers

Scholars have identified several conditions that impair consumers' ability to make optimal borrowing decisions.<sup>106</sup> Among these are that many consumers lack the financial sophistication to understand loan documents.<sup>107</sup>

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<sup>105</sup> See *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and their Impact on Consumers: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 15–16 (statement of Michael D. Donovan, Partner, Donovan Searles, LLC):

Disclosures are only useful for consumers when all of the following conditions exist –

- The consumer has the opportunity to read the disclosures fully;
- The disclosures are unambiguous and understandable;
- The disclosures are true and apply to the entire term of the contract;
- The consumer has the knowledge and sophistication to understand the meaning of the information provided in the disclosures;
- The consumer has the opportunity to make choices based on the information gained through the disclosures.

The TILA disclosures seemingly fail on all of these counts.

<sup>106</sup> See Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?* 4 (Fed. Reserve Bank of Chi., Working Paper No. 2006-119, 2006), available at <http://ssrn.com/abstract=843826> (finding that about 40% of credit card customers chose sub-optimal contracts).

<sup>107</sup> See, e.g., U.S. GEN. ACCOUNTING OFFICE, GAO-04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 97 (2004) [hereinafter GAO: CONSUMER PROTECTION] (“Even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities.”); Engel & McCoy, *supra* note 72, at 1280 (“[T]he typical victims of predatory lenders are unsophisticated about their options.”); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707, 728 (2006) (“[S]ubprime loan pricing and structure are nontransparent to many consumers, creating information asymmetries between borrowers and loan sellers that can be exploited by the latter.”); ESSENE & APGAR, *supra* note 68, at iii–iv (“Given that the mortgage transaction has multiple time and cost dimensions, consumers often are unable to determine what actual risks they face over time. . . . While standard economic theory assumes that consumers shop for the best available price and terms, even the most sophisticated borrowers often find it difficult to effectively shop for mortgages.”); Press Release, Consumer Federation of America, Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Rate Mortgages (July 26, 2004), available at

In Judge Posner's words, "not all persons are capable of being careful readers."<sup>108</sup> Some borrowers either do not realize they need to know more,<sup>109</sup> or do not wish to incur or cannot afford the cost of acquiring more information.<sup>110</sup> The result is described by a former mortgage lender: "On many occasions I've seen borrowers at the closing table develop that deer in the headlights look."<sup>111</sup> When borrowers cannot appreciate the significance of loan terms, lenders are free to do with those terms what they will.<sup>112</sup>

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[http://consumerfed.org/elements/www.consumerfed.org/file/housing/072604/ARM\\_Survey\\_Release.pdf](http://consumerfed.org/elements/www.consumerfed.org/file/housing/072604/ARM_Survey_Release.pdf).

Significant numbers of consumers are financially illiterate. See Lewis Mandell, *Consumer Knowledge and Understanding of Consumer Credit*, 7 J. CONSUMER AFF. 23, 35 (1973) ("[W]ith the exception of those who are well educated and fairly affluent, most consumers have great gaps in their knowledge and understanding of the credit market."); Annamaria Lusardi, *Financial Literacy: An Essential Tool for Informed Consumer Choice?* 2 (Nat'l Bureau of Econ. Research, Working Paper No. W14084, 2008), available at <http://ssrn.com/abstract=1149331> ("[M]ost individuals cannot perform simple economic calculations and lack knowledge of basic financial concepts . . . . [I]gnorance about basic financial concepts can be linked to . . . poor borrowing behavior."); see also Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 237-39 (2002) ("[L]arge numbers of adults have limited quantitative literacy skills. . . . 96% of American adults cannot extract and compute credit cost information from contract and disclosure documents. . . . The degree of literacy required to comprehend the average disclosure form and key contract terms simply is not within reach of the majority of American adults."); José Antonio Rosa, Madhubalan Viswanathan, & Julie A. Ruth, *Emerging Lessons*, WALL ST. J., Oct. 20, 2008, at R12 (reporting that 14% of Americans are estimated to be functionally illiterate).

<sup>108</sup> *Emery v. Am. Gen. Fin.*, 71 F.3d 1343, 1347 (7th Cir. 1995); see also Durkin & Elliehausen, *supra* note 17; at 128 ("There can be little doubt, however, that understanding credit disclosures is daunting for most recipients and beyond the capabilities of some to absorb the information.").

<sup>109</sup> Bar-Gill & Warren, *supra* note 39, at 12 ("Consumers do not seek to acquire more information because they are not aware that they need more information or that more information is available for them to acquire. Put differently, an imperfectly rational consumer might not be aware of the fact that she is uninformed.").

<sup>110</sup> *Id.* at 13 ("Consumers are uninformed because information is costly to acquire.").

<sup>111</sup> BITNER, *supra* note 44, at 133.

<sup>112</sup> See Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1207 (2003) ("When a contract term is non-salient to most purchasers, the market check on seller overreaching is absent, and courts should be suspicious of the resulting term. Put slightly differently, whenever a term in a form contract is non-salient to most purchasers, those purchasers are incompetent to protect their interests vis-à-vis that term."); cf. Becher & Unger-Aviram, *supra* note 99, at 3 ("[W]here consumers are not aware of the content of their contracts, sellers have a profit incentive to provide contractual terms of the lowest quality possible.").

Indeed, some lenders have sought out unsophisticated borrowers because of their inability to recognize the unsuitability of loan offers,<sup>113</sup> while others target borrowers experiencing financial stress who may consequently be less able to give loan terms their full attention.<sup>114</sup> Some of these lenders employ high-pressure tactics, which further diminish the ability of borrowers to think through their decisions.<sup>115</sup>

The complex loans typical in subprime lending also worsen the problem by making it more difficult for borrowers to understand their loan terms.<sup>116</sup>

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<sup>113</sup> See, e.g., Engel & McCoy, *supra* note 72, at 1281–83 (describing how predatory lenders identify unsophisticated borrowers and noting “hard-sell tactics capitalize on . . . borrowers’ lack of experience with this new breed of lenders and their complex products”); Linda E. Fisher, *Target Marketing of Subprime Loans: Racialized Consumer Fraud & Reverse Redlining*, 18 BROOK. J.L. & POL’Y 121, 124 (2009) (“Employing techniques ranging from sophisticated demographic analyses of defined geographic areas to arrangements with local brokers in low-income urban neighborhoods, these subprime lenders focused on borrowers with little knowledge of mortgage lending in general and their own financial options in particular.”). But see FTC Workshop, *supra* note 44, at 154 (statement of Paul Willen, Federal Reserve Bank of Boston) (Lenders “targeted the most complex mortgages to the most sophisticated borrowers.”).

<sup>114</sup> Willis, *supra* note 107, at 770 (“Subprime home lender marketing strategies attempt to reach potential borrowers at times of stress, when the borrowers are more likely to truncate their reasoning. One method is to target marketing efforts to consumers whom sellers know to be in some financial crisis.”).

<sup>115</sup> See, e.g., Engel & McCoy, *supra* note 72, at 1307 (“This state of affairs puts unsophisticated loan applicants at risk of high-pressure tactics at closing, where borrowers may learn for the first time that they will be paying higher interest, points, or fees. Confronted by surprise disclosures, they need financial or legal advice at the exact moment that they have to commit. Without that advice, fearful that they will lose their loans and desperate for funds, most borrowers sign the closing documents.”); see also GOLDSTEIN, *supra* note 47, at 62 (“One former loan officer at a national subprime lender stated in an interview that loans are pushed hard once a lead is found. He stated that, upon receiving leads, loan solicitors begin ‘badgering the hell’ out of potential borrowers, calling them at least four times per day. He said that loan officers are taught very specific ways to market their loans, from always including a cashout provision to selling to the borrower’s emotions—to ‘sell the dream.’”).

<sup>116</sup> See, e.g., Engel & McCoy, *supra* note 72, at 1284 (“[P]redatory lenders rarely make plain-vanilla, fixed-rate loans with easily understood payment terms. Most predatory loans contain terms that require borrowers to make difficult probabilistic computations about the likelihood and magnitude of future market events that are entirely outside their control.”); Woodward, *Consumer Confusion*, *supra* note 75, at 4; BARR ET AL., *supra* note 48, at 8 (“How many homeowners really understand how the teaser rate, introductory rate and reset rate relate to the London interbank offered rate plus some specified margin, or can judge whether the prepayment penalty will offset the gains from the teaser rate?”); ESSENE & APGAR, *supra* note 68, at i, 15 (“[M]any consumers have a limited ability to evaluate complex mortgage products and they often make choices which

Thus, the Government Accountability Office found that disclosures for complex mortgage loans “were generally written with language too complex for many adults to fully understand,”<sup>117</sup> as is surely true of the loan term quoted above.<sup>118</sup> Choosing among different types of loans, even from the same lender, requires understanding many such terms.<sup>119</sup> Oren Bar-Gill and

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they regret after the fact. . . . Unlike simple products that typically have a single price component, loan pricing is a combination of interest rates, points, fees, prepayment penalties, and other factors. Moreover, features such as interest rates and prepayment penalties vary constantly in response to changing economic conditions. This makes it difficult for consumers to track, no less learn how the various components of price relate to one another.”); *see also* GAO: ALTERNATIVE MORTGAGE PRODUCTS, *supra* note 10, at 2 (Alternative mortgage products “often have complicated terms and features” and so consumers may not fully understand their risks); Bar-Gill, *supra* note 68, at 1102–03; Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 808, 890–91, 901 (2003) (describing how high-cost lenders strategically try to keep price hidden as long as possible and how one way they do so is by making their products complex to hinder understanding: “The result is that there is no single easily comparable figure which describes the price a borrower will pay for financing—but, to the casual observer *it looks like there is.*”); Willis, *supra* note 107, at 766 (“Because subprime loan structures are more complicated than prime loan structures, subprime borrowers must attend to even more loan features than prime borrowers to assess loan price, and thus they are more likely to become overloaded when attempting the task.”); Zywicki & Adamson, *supra* note 2, at 56 (“The difference in outcomes between the prime and the subprime market may be partly the result of different levels of sophistication or education among borrowers, but more important is that subprime loans are simply more complex than prime mortgages, both in the complexity of the individual terms (for example, adjustable versus fixed rates) and the total number of relatively complex terms.”); ESSENE & APGAR, *supra* note 68, at 11.

<sup>117</sup> GAO: ALTERNATIVE MORTGAGE PRODUCTS, *supra* note 10, at 9. The GAO added, at pages 8–9:

AMP disclosures generally did not conform to leading practices in the federal government, such as key “plain English” principles for readability or design. . . . Most of the disclosures also used small, hard-to-read typeface, which when combined with an ineffective use of white space and headings, made them even more difficult to read and buried key information.

<sup>118</sup> *See supra* notes 22–23 and accompanying text.

<sup>119</sup> Bar-Gill explains:

Consider a borrower facing a 2-28 hybrid and an option ARM: The 2-28 has an introductory period and an initial rate. The option ARM has a different introductory period during which four different payment options are available. The 2-28 specifies an index and a margin for the postintroductory period with certain caps on rate adjustments. The option ARM specifies a different index, a different margin, and different adjustment caps. . . . In reality the borrower must choose between more than two products.



Elizabeth Warren have observed that “comparison among [mortgage] contracts is challenging even for a professional.”<sup>120</sup> Consumers are also barraged with an assortment of fees, which may be itemized separately, further distracting them from contemplating whether the loan is beyond their reach.<sup>121</sup> The result, in Susan Wachter’s words, is that “[i]t is nearly impossible in the subprime world to shop.”<sup>122</sup>

Many consumers do so little searching for mortgages when they do seek one that they are not likely to acquire the needed expertise even then.<sup>123</sup> One study found that even after the mortgage meltdown, the average borrower spent five hours shopping for a mortgage, while 31% spent two hours or

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Bar-Gill, *supra* note 68, at 1106 (footnote omitted).

<sup>120</sup> Bar-Gill & Warren, *supra* note 39, at 13; *see also* Joan Warrington, on Durkin & Elliehausen, *supra* note 17, in *THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT* 145, 146 (Thomas A. Durkin & Michael E. Staten eds., 2002) (“Even with a law degree and a career in consumer credit, I still have problems understanding many of the disclosures that I see.”).

<sup>121</sup> Bar-Gill, *supra* note 68, at 1102–06 (2009) (listing numerous fees).

<sup>122</sup> FTC Workshop, *supra* note 44, at 18 (statement of Susan Wachter); *see also* Peterson, *supra* note 116, at 890 (“[T]here are strong indications that, at least in the market for high-cost credit, Truth in Lending has failed almost entirely in promoting price informed borrowing decisions among the most vulnerable debtors.”).

<sup>123</sup> Jinkook Lee & Jeanne M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else*, 9 FIN. SERVS. REV. 277, 285, 288 (2000) (reporting that 40% of consumers seeking mortgages “claimed to do almost no searching or only a little searching; about one-third (32%) reported doing a moderate amount of search and over one-fourth (28%) claimed to do a lot or a great deal of searching. . . . [T]he median number of loans compared was 3 and the median number of terms and features considered was 6. . . . One out of seven refinancers (15%) reported they did not compare any terms and one-fourth (26%) of other mortgage borrowers reported not comparing any terms.”); ICF MACRO REPORT, *supra* note 33, at iii (“Only about half of [the focus group members] consulted more than one lender or broker when looking for a mortgage loan.”); REEDHALDYMCINTOSH, *INSIGHTS INTO THE MINORITY HOMEBUYING EXPERIENCE: THE MORTGAGE APPLICATION PROCESS* 9 (2003), *available at* <http://www.nw.org/network/comstrat/minorityownership/documents/insights.pdf> (most homebuyers in their focus groups “did not actually comparison-shop for the best terms for their mortgage. Many did not think such comparisons were possible.”); *see id.* at 9 (“The few [focus group] participants who considered multiple mortgage applications to permit closer comparisons were discouraged from doing this by the penalties associated with repeated requests for credit scores.”); *see also* Truth in Lending, 73 Fed. Reg. 44,525 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (“In this environment of limited transparency, consumers—particularly those in the subprime market—may reasonably decide not to shop further among originators or among loan options once an originator has told them they will receive a loan, because further shopping can be very costly. Shopping may require additional applications and application fees, and may delay the consumer’s receipt of funds.”).

less.<sup>124</sup> The Fed has concluded that “[d]isclosures themselves, likely cannot provide this minimum understanding for transactions that are complex and that consumers engage in infrequently.”<sup>125</sup> And advertising does not cure the problem, because it often focuses on price options not available to all consumers, and so may add to, rather than dispel confusion.<sup>126</sup> Similarly, the Government Accountability Office has observed that advertising for alternative mortgage products (AMPs) “sometimes emphasizes the benefits of AMPs over their risks,” leading to confusion.<sup>127</sup>

Consumers lacking the ability to understand their loan terms may turn to mortgage originators for help.<sup>128</sup> Thus, the FTC study explained: “Many of

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<sup>124</sup> *Despite Mortgage Meltdown, Today's Borrowers Continue to Spend Twice as Much Time Researching a Car Purchase as Researching Their Home Loan*, ZILLOW, <http://zillow.mediaroom.com/index.php?s=159&item=201> (last visited Aug. 18, 2010).

<sup>125</sup> Truth in Lending, 73 Fed. Reg. 1,676 (proposed Jan. 9, 2008) (to be codified at 12 C.F.R. pt. 226).

<sup>126</sup> See *Atlanta Public Hearing*, *supra* note 10, at 155, 156 (statement of Patricia McCoy, University of Connecticut School of Law) (noting that lenders quote “their best prices in general advertisements, even if most of their subprime customers would not qualify for those prices. . . . Many of these ads are affirmatively misleading. They’ll have a low teaser rate, very low, that is really a prime market teaser rate. And then, say, bad credit, no problem in the same ad. That lures people in. There will be no disclaimer that the interest rate could go up, according to your credit worthiness.”); ESSENE & APGAR, *supra* note 68, at 16.

<sup>127</sup> GAO: ALTERNATIVE MORTGAGE PRODUCTS, *supra* note 10, at 2. The GAO elaborated at page 7:

For example, one advertisement we reviewed promoted a low initial interest rate and low monthly mortgage payments without clarifying that the low interest rate would not last the full term of the loan.

In other cases, promotional materials emphasized the benefits of the AMPs without effectively explaining the associated risks. Some advertising, for example, emphasized loans with low monthly payment options without effectively disclosing the possibility of interest rate changes or mortgage payment increases. One print advertisement we reviewed for a payment-option ARM emphasized the benefits of a low initial interest rate but noted in small print on its second page that the low initial rate applied only to the first month of the loan and could increase or decrease thereafter.

<sup>128</sup> Kellie K. Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans*, 83 AARP PPI DATA DIGEST 1, 3 (2003), available at [http://assets.aarp.org/rgcenter/post-import/dd83\\_loans.pdf](http://assets.aarp.org/rgcenter/post-import/dd83_loans.pdf) (study finding 70% “of older borrowers with broker-originated refinance loans reported that they relied ‘a lot’ on their brokers to find the best mortgage for them”); see also Truth in Lending, 73 Fed. Reg. 44,526 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (“[C]onsumers may rely more on their originators to

the respondents who said that they understood the disclosures reported that they had not been able to understand the disclosures on their own, but had relied on their originators or closing agents to explain them.”<sup>129</sup> Again, that is consistent with the finding in our study that most brokers explained the disclosures to their borrowers. But another study found that not all borrowers were satisfied with the ensuing results.<sup>130</sup> While it is undoubtedly the case that many loan originators offer excellent advice, others clearly do not. Because mortgage brokers are typically compensated for arranging for loans, and not for counseling against borrowing, they have an incentive to encourage consumers to borrow,<sup>131</sup> and in fact some critics claim that some originators actively mislead borrowers. Kathleen C. Engel and Patricia A. McCoy have reported that “[s]ome lenders resort to out-and-out fraud. Other, more sophisticated lenders make truthful disclosures as required by law, but use a variety of hard-sell tactics.”<sup>132</sup> Thus, Michael Hudson described the experiences of loan officer Philip White in these words:

He entered a world, he says, where cunning and deception were standard tools of the trade, where customers were routinely snowed by confusing

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explain the disclosures when the transaction is complex.”); Lee & Hogarth, *supra* note 123, at 285 (“Lenders, specifically, banks, savings and loans, and credit unions were the most popular sources for information.”).

<sup>129</sup> LACKO & PAPPALARDO, *supra* note 47, at 31; *see also id.* at ES-6 (“Other[] [borrowers] relied primarily on their loan officer or mortgage broker to explain the loan terms . . . rather than examining and verifying the loan terms themselves.”); *cf.* Willis, *supra* note 107, at 766 (“[M]any borrowers think they do not have to price shop because they are paying a broker or loan officer to do that for them.”).

<sup>130</sup> *See* Kim-Sung & Hermanson, *supra* note 128, at 4 (2003) (21% of older borrowers in study “reported that they did not receive a loan that was best for them;” 23% said they did not feel the rates and terms of their mortgage were fair; and 19% felt they had not received “accurate and honest information about their loans”).

<sup>131</sup> Truth in Lending, 73 Fed. Reg. 44,526 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (“[S]ome originators may have incentives to misrepresent the disclosures so as to obscure the transaction’s risks to the consumer; and such misrepresentations may be particularly effective if the originator is face-to-face with the consumer.”); Bar-Gill, *supra* note 68, at 1128–29 (“Borrowers commonly seek the advice of mortgage brokers who face an incentive structure that prevents them from being loyal agents of the borrower.”).

<sup>132</sup> Engel & McCoy, *supra* note 72, at 1283; *see also* GAO: CONSUMER PROTECTION, *supra* note 107, at 94 (“[A]busive lenders and brokers may use high-pressure or ‘push marketing’ tactics—such as direct mail, telemarketing, and door-to-door contacts—that are unfair, deceptive, or designed to confuse the consumer.”); GRAMLICH, *supra* note 78, at 33 (predatory lenders often “have loan quotas to meet, regardless of whether the loans would do the borrowers any good, and their salespeople use high-pressure techniques to meet their quotas.”).

paperwork and sleight-of-hand salesmanship. . . . White, who eventually rose to assistant branch manager, claims customers were also misled about upfront points and other finance charges. The attitude was: "If you had to lie about the points that we charged, lie to 'em. They're stupid anyway."<sup>133</sup>

And a predatory lender testified before Congress:

I have seen finance company employees commit forgery on a massive scale. These employees have forged everything from insurance forms, RESPA documents, income verification forms, and even entire loan files. . . .

. . . .

. . . I can get around any figure on any loan sheet. . . .

. . . .

. . . The customers believe what I tell them.<sup>134</sup>

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<sup>133</sup> Michael Hudson, *Signing Their Lives Away: Ford Profits from Vulnerable Consumers*, in *MERCHANTS OF MISERY: HOW CORPORATE AMERICA PROFITS FROM POVERTY* 42 (Michael Hudson ed., 1996); see *id.* at 42 (reporting on experiences of loan officer Philip White: "Many customers didn't—or couldn't—read their loan documents. . . . White says they frequently never saw forms disclosing broker's fees, and loan officers often added in hundreds, even thousands of dollars in charges for credit insurance—without asking them if they needed it. White says higher-ups told him, 'If you don't have to tell 'em and they don't ask, don't tell 'em. Just get 'em to initial it. They're big people. They can read—most of them anyway.'"); see also *Jacobson Aff.*, *supra* note 77, at 4, 6 (stating that loan officers told customers that pre-payment penalties could be waived when in fact they could not be and that some loan officers falsified loan applications); *Paschal Aff.*, *supra* note 77, at 7 ("[I]t was implied in trainings that Wells Fargo loan officers should not mention that subprime loans included a prepayment penalty if the borrower paid off or refinanced his loan before the prepayment penalty period ended or that the monthly payments on the ARM loans would substantially increase. When an applicant asked a loan officer about prepayment penalties or monthly payment increases, the loan officer would tell the applicant not to worry because Wells Fargo would later be able to refinance him into a prime or an FHA loan."); Hudson, *supra*, at 42; TED JANUSZ, *KICKBACK: CONFESSIONS OF A MORTGAGE SALESMAN* 7–9 (2006) (describing how his firm employed attractive scantily-clad closing agents to distract borrowers from reading the numbers at the closing so the firm could manipulate the figures).

<sup>134</sup> *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing Before the Senate Special Committee on Aging*, 105th Cong. 34, 37, 38 (statement of "Jim Dough") (pseudonym); see also LACKO & PAPPALARDO, *supra* note 47, at 29–30 (Borrowers' "various misunderstandings also suggest that loan originators,

Similarly, the authors of one study of borrowers in certain Chicago zip codes, after noting that the “overwhelming majority” of borrowers with adjustable-rate loans believed that they had fixed-rate loans, observed: “In every case where borrowers were surprised to be told they were receiving an adjustable rate loan, the Loan Originator had told the borrower that the rate was ‘fixed’ but neglected to mention that the term for which the rate was ‘fixed’ was limited to 12 to 36 months.”<sup>135</sup>

It thus appears that some consumers believe what they are told rather than what they read—if they read—in disclosure documents.<sup>136</sup> Lenders who engage in such tactics find easy prey in those who cannot understand their loan terms and so lack the capacity to discover that they are being deceived.<sup>137</sup>

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at least in some cases, may have misled borrowers about the features of their loans, and that the current disclosures were not sufficient to overcome these deceptions.”); ILL. DEP’T OF FIN. AND PROF’L REGULATION, *supra* note 10, at 4 (2007) (“*Borrowers tend to trust what they are told by their Loan Originator or Mortgage Broker rather than reading and understanding what is written in the Disclosures given to them.*” (emphasis added)).

<sup>135</sup> ILL. DEP’T OF FIN. AND PROF’L REGULATION, *supra* note 10, at 3–4.

<sup>136</sup> *Atlanta Public Hearing*, *supra* note 10, at 166 (statement of John C. Kozup, Director, Center for Marketing and Public Policy, Villanova University) (“I was on the phone this morning with a member of my advisory board who runs a bank. He says, I’ve closed thousands of real estate loans. They don’t read [disclosures]. I cannot think of a handful of times when the customers came in with questions about it. He said, they trust me.”).

<sup>137</sup> LACKO & PAPPALARDO, *supra* note 47, at 123 (“Consumers who do not recognize key loan costs also will be more vulnerable to deceptive lending practices that aim to hide or misrepresent loan costs. The failure of the current disclosures to convey key loan costs to many consumers may make it easier for some lenders to engage in deceptive practices. Many of the FTC’s deceptive lending cases have involved loan terms that the current disclosure forms have particular difficulty conveying to consumers, such as optional credit insurance, balloon payments, prepayment penalties, and the financing of high fees and optional charges in the loan amount. Lenders in these cases may have used deceptive practices to take advantage of the inability of many consumers to recognize these terms in the current disclosure forms.”); *see also* GAO: CONSUMER PROTECTION, *supra* note 107, at 97–98 (“[R]evised disclosure requirements would not necessarily help protect consumers against lenders and brokers that engage in outright fraud or that mislead borrowers about the terms of a loan in the disclosure documents themselves.”); Zywicki & Adamson, *supra* note 2, at 73 (“In short, due to the complexity and sheer volume of documentation associated with a home mortgage, there is a large information asymmetry between borrowers and lenders that makes borrowers highly vulnerable to fraud and oppression by lenders.”). Nor does it seem to matter that borrowers can choose among many mortgage originators. *See* Richard M. Hynes & Eric A. Posner, *Law and Economics of Consumer Finance* 6 (Univ. Chicago Law & Economics, Olin Working Paper No. 117, 2001), *available at*

Even originators who will not stoop to outright lies may find it both useful and possible to confuse borrowers as to loan costs,<sup>138</sup> by, for example, increasing the transaction costs borrowers incur in deciphering loan terms.<sup>139</sup> Thus, originators may manipulate fees to complicate disclosures;<sup>140</sup> they have an incentive to hide as many costs as possible, thereby making loans

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[http://papers.ssrn.com/paper.taf?abstract\\_id=261109](http://papers.ssrn.com/paper.taf?abstract_id=261109) (“Even if there are numerous lenders in a market, each lender may have some degree of market power because of the inability of consumers to costlessly compare prices and terms. Depending on the source of the information failure, this may result in either an abnormally high price or abnormally harsh terms. Some creditors will lend only to those consumers who are unable to compare the (price or nonprice) terms of the loan offered with the terms available elsewhere in the market.”).

<sup>138</sup> See *Improving Federal Consumer Protection in Financial Services: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 98 (2007) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation) (“In addition to the complexity of the underlying product, aggressive or misleading marketing can have a negative impact on the ability of borrowers to make informed credit decisions. Without complete and balanced information, consumers may not realize that they may be unlikely to afford the required monthly payments of credit products—particularly when a loan includes an initial teaser interest rate that will expire.”); ESSENE & APGAR, *supra* note 68, at ii (“[S]ome marketing and sales practices appear to cross the line. Instead of supporting informed choices, aggressive and misleading marketing can play on consumer fears and lack of knowledge. In fact, some individuals and firms on the market’s supply side use their considerable knowledge of consumer behavior to aggressively “push market” inappropriate mortgage products.”).

<sup>139</sup> See generally Jeff Sovern, *Toward a New Model of Consumer Protection: The Problem of Inflated Transaction Costs*, 47 WM. & MARY L. REV. 1635 (2006).

<sup>140</sup> See Bar-Gill, *supra* note 68, at 1122 (“Increased complexity may be attractive to lenders, as it allows them to hide the true cost of the loan in a multidimensional pricing maze. . . . For example, if the tax certification fee and the late payment fee are not salient to borrowers, lenders will raise the magnitude of these price dimensions. Increasing these prices will not hurt demand. On the contrary, it will enable the lender to attract borrowers by reducing more salient price dimensions. This strategy depends on the existence of nonsalient price dimensions. When the number of price dimensions goes up, the number of nonsalient price dimensions can also be expected to go up. Lenders thus have a strong incentive to increase complexity and multidimensionality.” (citation omitted)); Willis, *supra* note 107, at 724–25; see also Bar-Gill & Warren, *supra* note 39, at 54 (“Mortgage borrowing is much more complex because lenders have disaggregated fees. The cost of borrowing money now includes a number of fees, such as origination fees (including document-preparation fees, underwriting-analysis fees, tax-escrow fees, and escrow-fund-analysis fees) that are often not disclosed until late in the purchasing process. It is as if a person purchasing a car discovered only at the time of sale that there would be additional charges for paint, for a bumper, and for tires. Such additional charges would likely be omitted from the buyer’s initial estimates of affordability and would escape inclusion as the buyer compared different loan options.”).

look more affordable,<sup>141</sup> or to use terminology that implies cheaper loans. For instance, Susan Woodward found that borrowers who pay “discount points” to mortgage brokers end up paying “an extra \$109 in total costs for each \$100 paid in points.”<sup>142</sup> Oren Bar-Gill and Elizabeth Warren have added that “sellers design their products to exploit consumers’ imperfect information and imperfect rationality.”<sup>143</sup>

A November 1997 First Alliance Mortgage Company loan officer training manual, titled “FAMCO Loan Officer Track” (Track Manual), together with the affidavit of a former First Alliance loan officer, illustrate one way predatory lenders sell loans.<sup>144</sup> The Track Manual, which includes a script for officers to use when speaking with loan applicants, opens with standard instructions about smiling, appearing likeable and building a rapport.<sup>145</sup> Every page is stamped “confidential,” and many include a box with the words “Remember: It is FAMCO’s policy to disclose completely and fully all aspects of the loan transaction.”<sup>146</sup> At many stages, the script directs the loan officer to ask if the borrower has any questions: “*How about the questions you were afraid to ask? How about the ones you were a little embarrassed to ask? How about the ones you’ll wish you asked when you get home?*”<sup>147</sup> So far, so good.

The Track Manual also directs loan officer to offer helpful advice to borrowers, warning borrowers against making late payments: “*Don’t be late; it’s just money down the drain.*”<sup>148</sup> The script includes the following in bold print: “Often customers attempt to borrow more than what they really need. Since borrowing is so expensive, FAMCO generally suggests that the customers borrow the least amount they need & pay it back as fast as they can.”<sup>149</sup> But the point that is made most forcefully and frequently, and at considerable length, with diagrams, is that much of the money the borrower pays to the lender is interest, and the borrower can save a good deal of that by prepaying the mortgage: “*Did you realize that by the time you finish*

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<sup>141</sup> FTC Workshop, *supra* note 44, at 80 (statement of David Laibson) (“Firms are going to minimize the perceived costs of their loans. They are going to do that by putting as many of the costs as possible into the shrouded category.”).

<sup>142</sup> WOODWARD, STUDY OF CLOSING COSTS, *supra* note 75, at 62.

<sup>143</sup> Bar-Gill & Warren, *supra* note 39, at 46.

<sup>144</sup> Apparently later editions of the Track Manual exist. See *In re First Alliance Mortg. Co.*, 298 B.R. 652, 657 (C.D. Cal. 2003) (referring to April 1999 edition).

<sup>145</sup> See FAMCO Loan Officer Track 5 (1997) (on file with author).

<sup>146</sup> See, e.g., *id.* at 28.

<sup>147</sup> *Id.* at 38.

<sup>148</sup> *Id.* at 26.

<sup>149</sup> *Id.* at 22.

*paying off this house, you actually agreed to pay off at least 3 houses?"*<sup>150</sup>  
The point is made again:

*[T]here are basically two ways to save money on a mortgage, aren't there? By reducing the rate or by shortening the term. But the best way is to do both, isn't it? Unfortunately, [at this point, the loan officer is to point to a diagram] when you shorten the term, you raise the payment. And, who wants that? Wouldn't it be great to lower the overall rate, shorten the overall term, and keep the overall payments the same or lower? Then you'd kill 3 birds with one stone, wouldn't you?"*<sup>151</sup>

And again: *"All you have to do is to send in an extra \$224.70 per month with your payment. And if you do that every month, you'll have your house paid for completely in 15 years instead of 30 years."*<sup>152</sup>

All true, and unobjectionable. Perhaps the Track Manual's authors feared that it would end up becoming public, or disclosed in litigation, and so wrote it with that in mind, or perhaps their hearts were pure. But the affidavit of Greg Walling, a former First Alliance loan officer, puts the Track Manual in a different light.<sup>153</sup> Walling went through FAMCO's month-long training program, which included "memorizing and practicing delivery of the Track presentation."<sup>154</sup> Walling explained:

The Track presentation and First Alliance's sales methods are highly effective at getting consumers to enter into loans without understanding the fees charged for the loan or the increasing interest rate on the ARM loans. First Alliance charges loan fees for home refinancing loans that are incredibly high, even for the "subprime" market segment. First Alliance leads consumers to enter into loans for which the consumer does not understand the amount of loan fees that he or she has been charged by First Alliance. The vast majority of First Alliance borrowers obtain an adjustable rate mortgage ("ARM"). These consumers also do not understand that their ARM loan from First Alliance has a "teaser rate" that will adjust upwards

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<sup>150</sup> *Id.* at 6.

<sup>151</sup> FAMCO Loan Officer Track, *supra* note 145, at 20.

<sup>152</sup> *Id.* at 28.

<sup>153</sup> Affidavit of Greg Walling, Memorandum in Support of the State's Motion for a Temporary Injunction, *State v. First Alliance Mortg. Co.*, No. C9-98-11416, Minn. Dist. Ct., 2d Judicial Dist., Cnty. of Ramsey (filed on Dec. 21, 1998) [hereinafter Walling Aff.].

<sup>154</sup> Walling Aff., *supra* note 153, at 2.



by several percentage points if market interest rates do not change after the date of loan closing.<sup>155</sup>

As for the helpful advice, Walling affied:

The first nine steps of the Track presentation get the consumer to think about the total cost of paying off the mortgage over thirty years, rather than the costs and fees for writing the loan. In other words, the Track focuses the consumer's attention solely on the idea that the most important part of a mortgage is paying back the loan in a shorter time. In my experience, if the consumer bought into the idea that time was the enemy in a mortgage, he or she was unlikely to notice, understand or raise questions about the huge loan fees charged by First Alliance.<sup>156</sup>

Walling's affidavit also accounted for why the TILA disclosures—and particularly the APR disclosure—did not dissuade borrowers:

I also described the term APR to the consumer. I told the consumer that when we talk about loans we talk about three different rates. The three rates I described were the “interest rate,” the “APR” and the “yield.” I told the consumer that the interest rate was what the consumer and I care about, that the APR is what the federal government cares about, and that the bank cares about the yield. I told consumers that APR was just an estimate and that it is always higher than the interest rate. [Walling then described how he drew a chart comparing the numbers on hypothetical loans.] . . .

. . . .

I explained to the consumer that as the term of the mortgage is shortened . . . the APR increases, the interest rate stays the same, and the yield decreases. I used the above chart to reinforce the message that it is the total payments on the loan that should be the only concern to the consumer and that “time” is the enemy with a mortgage. As I was trained, I never told consumers the reason that the APR increased and the yield decreased as the term of the mortgage was shortened was due to the origination fee being spread over a shorter term.<sup>157</sup> The only other information about APR I

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<sup>155</sup> *Id.* at 5.

<sup>156</sup> *Id.* at 6–7.

<sup>157</sup> The court elaborated on this point in *In re First Alliance Mortgage Co.*:

First Alliance's statement about the APR is correct in that the APR will increase as the loan term is shortened by extra principal payments. However, the reason the APR increases in this circumstance is that the loan origination fee and other loan fees, comprise a greater percentage of the “finance charge” while the “amount financed” is constant, and thus the finance charge rises as a percentage of

would ever share with the consumer was that it was calculated over the whole period of the loan. When I was questioned about the APR on any of the later disclosure forms, I would refer consumers back to the above hand-drawn chart or I would show the consumer the actual Note with the note rate, and I would try to re-focus their attention on the total payback over 30 years. I was trained by First Alliance to bring [the] customer's attention back to this hand-drawn chart whenever I received a question about APR. I would never say that APR was a measure for comparing the cost of credit or make any statement that suggested APR offered useful information to the consumer. I would always use the note interest rate when describing the cost or rate of the loan, not the APR . . . .

. . . .

Customers that agreed to the loan terms . . . were given numerous forms to sign. . . . This process usually only took about 15 minutes. It was easy to get these customers to sign the forms because I had already convinced them through the Track presentation that they understood the terms of the loan and what was important about those loan terms. When customers asked questions about the federal disclosure forms, I would reiterate the appropriate part of the Track presentation, or answer the questions as described above without ever telling them they were paying extremely high loan fees or a [sic] getting an interest rate that would significantly increase in about the first two years even if market rates remained stable.<sup>158</sup>

Walling described other techniques for avoiding answering questions from borrowers that might result in the borrower understanding how high First Alliance's fees were:

If the consumer persisted in asking about the amount of the loan, I would attempt to re-direct their inquiry. For example, if a couple asked how much they would owe if they paid off the loan tomorrow, I would respond by asking if they planned to pay off the loan tomorrow. When they said "no," I would say "then it really doesn't matter, does it?" Or I would respond to their question by saying that there was only one way that they

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the amount financed. The amount of the APR increase is considerably less with a lower loan origination fee and a shorter term loan. But with the huge First Alliance fees implicit in the example, the APR increase was dramatic. First Alliance intentionally did not disclose this information. This presentation led consumers to discredit the APR when it was later disclosed on the federally required Truth in Lending Statement.

298 B.R. 652, 657 (C.D. Cal. 2003).

<sup>158</sup> Walling Aff., *supra* note 153, at 7–9, 13.

could pay off the loan tomorrow, and that would be to win the lottery, in which case none of what we talked about today would matter.<sup>159</sup>

Walling also reported that he would leave borrowers alone in a room, and eavesdrop on them discussing what terms they would find acceptable, which First Alliance would then use in fashioning its offer.<sup>160</sup>

First Alliance's tactics are obviously troubling, and ultimately brought it to a bad end; in the words of the Ninth Circuit, it "was driven into bankruptcy and subsequent liquidation by well-publicized and justified allegations of fraudulent lending practices."<sup>161</sup> Yet its practices find echoes in the survey of mortgage brokers, in that borrowers were not familiar with the APR disclosure, went through the TILA forms quickly, and seemed not to use them to make decisions.

Of course, many originators eschew all of these tactics. But that does not mean that they view it as their role to convey to borrowers the risks they will assume by agreeing to a mortgage. New York Times reporter Edmund L. Andrews quoted loan officer Bob Andrews of the now-defunct American Home Mortgage Corporation:

"I am here to enable dreams," he explained to me . . . . Bob's view was that if I'd been unemployed for seven years and didn't have a dime to my name but I wanted a house, he wouldn't question my prudence. "Who am I to tell you that you shouldn't do what you want to do? I am here to sell

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<sup>159</sup> *Id.* at 11. Among the findings of fact the court made in *In re First Alliance Mortgage Co.* were:

First Alliance's loan presentation was designed to obfuscate the loan origination fee, and other fees and prepaid interest and true principal sum of the loan from the consumer borrower. . . .

. . . .

First Alliance's loan officers were taught to present the state and federal disclosure documents in a manner that was both confusing and misleading. The presentation was so well performed that borrowers had no idea they were being charged points and other fees and costs averaging 11 percent above the amount they thought they had agreed to borrow. This amount did not include the undisclosed loan origination fees, other miscellaneous fees, or prepaid interest charged to the borrowers.

298 B.R. at 657–58.

<sup>160</sup> Walling Aff., *supra* note 153, at 12.

<sup>161</sup> *In re First Alliance Mortg. Co.*, 471 F.3d 977, 983 (9th Cir. 2006).

money and to help you do what you want to do. At the end of the day, it's your signature on the mortgage—not mine.”<sup>162</sup>

Nor does anyone else in the mortgage lending system have an incentive to explain to borrowers the risks of assuming large obligations. In David Laibson's words:

[I]n the mortgage market, there are lots of choices that individuals will make that may be beneficial to a mortgage originating firm, and there is no economic incentive for another firm to de-bias the consumer who was involved in these transactions.

For example, who is going to say to a consumer, if you buy this large house, you will be spending too much of your income on housing? . . .

. . . [T]he market does not have an incentive to inform individuals about these facts, because the person who is going to make money . . . is the firm that is going to interact with the consumer who is, let's say, unaware of these possibilities.<sup>163</sup>

Brokers are also said to discourage borrowers from speaking to other brokers, thus reducing the likelihood that borrowers will learn of better terms.<sup>164</sup>

In addition, borrowers may suffer from cognitive disabilities that interfere either with their understanding of loan terms or their ability to appreciate the significance of the terms.<sup>165</sup> Information overload famously

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<sup>162</sup> Edmund L. Andrews, *My Personal Credit Crisis*, N.Y. TIMES SUNDAY MAG., May 17, 2009, at 48.

<sup>163</sup> FTC Workshop, *supra* note 44, 77–78 (statement of David Laibson).

<sup>164</sup> See BITNER, *supra* note 44, at 46 (“[B]rokers advise their borrowers not to talk to competing brokers . . .”).

<sup>165</sup> See Bar-Gill, *supra* note 68, at 1079–80 (noting that many borrowers are “imperfectly rational”); Bar-Gill & Warren, *supra* note 39, at 46 (“[I]mperfect information and imperfect rationality pervade credit product markets”); Debra Pogrund Stark & Jessica M. Choplin, *A Cognitive and Social Psychological Analysis of Disclosure Laws and Call for Mortgage Counseling to Prevent Predatory Lending*, 16 PSYCHOL. PUB. POL’Y & L. 85, 97 (2010) (listing fourteen “cognitive and social psychological factors that cause disclosure forms to be ineffective”); Marianne Bertrand et al., *What’s Psychology Worth? A Field Experiment in the Consumer Credit Market* 5 (Yale U. Econ. Growth Ctr. Discussion Paper No. 918, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=770389](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=770389) (experiment with South African consumers found that psychological manipulations affected demand for loans, and that psychological factors “appear relatively more effective . . . when the interest rate is high”); BARR ET AL., *supra* note 48, at 2 (“Because people are fallible and easily

degrades decision-making.<sup>166</sup> Moreover, studies have demonstrated that consumers suffer from systematic tendencies to optimism.<sup>167</sup> As Oren Bar-

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misled, transparency does not always pay off and firms sometimes have strong incentives to exacerbate psychological biases by hiding borrowing costs.”).

<sup>166</sup> See *Atlanta Public Hearing*, *supra* note 10, at 93 (statement of Ken Logan, Chairman-Elect, National Home Equity Mortgage Association) (“[I]t is NHEMA’s position and my personal experience as a lender that the quantity and nature of the information disclosed is simply too much and detailed for the average borrower to digest over any period of time and that borrowers would be better served by simpler and more targeted disclosures.”); Willis, *supra* note 107, at 767; Zywicki & Adamson, *supra* note 2, at 60 (“[B]orrowers can see up to fifty total disclosures, including those required by lenders and state laws.”). See generally John C. Bergstrom & John R. Stoll, *An Analysis of Information Overload with Implications for Survey Design Research*, 12 LEISURE SCI. 265 (1990); Kevin Lane Keller & Richard Staelin, *Effects of Quality and Quantity of Information on Decision Effectiveness*, 14 J. CONSUMER RES. 200, 211 (1987); Naresh K. Malhotra, *Information Load and Consumer Decision Making*, 8 J. CONSUMER RES. 419 (1982). Early studies included Jacob Jacoby et al., *Brand Choice Behavior as a Function of Information Load: Replication and Extension*, 1 J. CONSUMER RES. 33 (1974), and Jacob Jacoby et al., *Brand Choice Behavior as a Function of Information Load*, 11 J. MARKETING RES. 63 (1974). For criticism of the early Jacoby studies, see, e.g., Naresh K. Malhotra, *Reflections on the Information Overload Paradigm in Consumer Decision Making*, 10 J. CONSUMER RES. 436 (1984) (suggesting that information overload does occur, but that the early Jacoby studies did not demonstrate it); J. Edward Russo, *More Information is Better: A Reevaluation of Jacoby, Speller and Kohn*, 1 J. CONSUMER RES. 68 (1974); John O. Summers, *Less Information Is Better?*, 11 J. MARKETING RES. 467 (1974); William L. Wilkie, *Analysis of Effects of Information Load*, 11 J. MARKETING RES. 462 (1974). For Jacoby’s replies, see Jacob Jacoby et al., *Constructive Criticism and Programmatic Research: Reply to Russo*, 2 J. CONSUMER RES. 154 (1975), and Jacob Jacoby, *Information Load and Decision Quality: Some Contested Issues*, 14 J. MARKETING RES. 569 (1977). For studies rebutting the information overload effect, see Naresh K. Malhotra et al., *The Information Overload Controversy: An Alternative Viewpoint*, 46 J. MARKETING 27 (1982); Thomas E. Muller, *Buyer Response to Variations in Product Information Load*, 69 J. APPLIED PSYCHOL. 300 (1984); Debra L. Scammon, *“Information Load” and Consumers*, 4 J. CONSUMER RES. 148 (1977). For criticism of these last studies, see Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RES. 432 (1984). For criticism of the Keller & Staelin study cited above, see Robert J. Meyer & Eric J. Johnson, *Information Overload and the Nonrobustness of Linear Models: A Comment on Keller and Staelin*, 15 J. CONSUMER RES. 498 (1989). Keller and Staelin’s response appears at *Assessing Biases in Measuring Decision Effectiveness and Information Overload*, 15 J. CONSUMER RES. 504 (1989). For law review discussions of information overload, see David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277 (1986), criticized in Melvin Eisenberg, *Text Anxiety*, 59 S. CAL. L. REV. 305 (1986); Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices*, 59 S. CAL. L. REV. 329 (1986).

Gill has observed, optimistic borrowers may underestimate future payment hikes, overestimate future income, and assume that housing prices will rise so that future payment increases will not matter because they will be able to refinance.<sup>168</sup> Originators eager to make loans may exacerbate these tendencies.<sup>169</sup> In consequence, borrowers may not give sufficient consideration to future payment increases.<sup>170</sup> The problem is worsened still further by the tendency of adjustable-rate loan borrowers to underestimate the amounts by which their rates can increase.<sup>171</sup>

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<sup>167</sup> See David A. Armor & Shelley E. Taylor, *When Predictions Fail: The Dilemma of Unrealistic Optimism*, in *HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT* 334, 334 (Thomas Gilovich et al. eds., 2002) (“One of the most robust findings in the psychology of prediction is that people’s predictions tend to be optimistically biased.”); Melvin Aron Eisenberg, *The Emergence of Dynamic Contract Law*, 88 CAL. L. REV. 1743, 1782 (2000) (contracting parties tend to be “unrealistically optimistic”); Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1659 (1998) (“[P]eople are often unrealistically optimistic about the probability that bad things will happen to them. A vast number of studies support this conclusion.”); Dan N. Stone, *Overconfidence in Initial Self-Efficacy Judgments: Effects on Decision Processes and Performance*, 59 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 452, 453–54, 468 (1994) (citing studies that demonstrate consumer optimism); Cass R. Sunstein, *Hazardous Heuristics*, 70 U. CHI. L. REV. 751, 772–74 (2003) (“With respect to most of the risks of life, people appear to be unrealistically optimistic.”); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 806, 818–19 (1980).

<sup>168</sup> Bar-Gill, *supra* note 68, at 1078–79, 1119–20. These payment hikes may be significant. See FISHBEIN & WOODALL, *supra* note 72, at 20 (describing how monthly payments may more than double).

<sup>169</sup> See Truth in Lending, 73 Fed. Reg. 44,542 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (“[O]riginators may sometimes encourage borrowers to be excessively optimistic about their ability to refinance. . . . For example, they sometimes offer reassurances that interest rates will remain low and house prices will increase; borrowers may be swayed by such reassurances because they believe the sources are experts.”); Bar-Gill, *supra* note 68, at 1120–21.

<sup>170</sup> Willis, *supra* note 107, at 778 (“Components of loan price that are uncertain at the time of loan purchase, or that do not come into effect until sometime long after the first monthly payment, are almost certainly underweighted, if not ignored altogether, in borrower decisionmaking. The popularity of loans with ‘teaser rates,’ adjustable rates that will, with certainty, increase in six months or a year, is due to this bias. Consumers are even more likely to fail to appreciate the true future costs of a loan when these costs are not only in the future, but also uncertain, such as where the interest rate is tied to an index.” (footnote omitted)).

<sup>171</sup> See Bucks & Pence, *supra* note 51, at 2.

Consumers in the late stages of taking out a loan may also experience the status quo effect—a preference for staying with the status quo<sup>172</sup>—or a variant of the endowment effect, the tendency of consumers to want to retain possessions they have had, however briefly.<sup>173</sup> The status quo for a consumer obtaining a loan is to proceed with the loan. Similarly, though, strictly speaking, a loan is not a possession; the proceeds of the loan enable consumers to obtain a possession: a house, or in the case of a refinancing, perhaps home renovations or additional purchases. While the consumer will not possess those proceeds until the closing, perhaps the anticipation functions just as the endowment effect does: to increase the desire of the consumer to retain the item they have dreamed of.<sup>174</sup> In any event, both effects may drive consumers to move forward with the loan, regardless of its merits.

In short, consumers contemplating borrowing may encounter originators with an interest in persuading them to borrow—an interest that sometimes drives originators to act badly—but our existing system does not provide borrowers with anyone with a contrary interest or a neutral perspective to expose them to the arguments against borrowing. Those arguments are

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<sup>172</sup> See Eric J. Johnson et al., *Framing, Probability Distortions, and Insurance Decisions*, in CHOICES, VALUES, AND FRAMES 224, 235–38 (Daniel Kahneman & Amos Tversky eds., 2000); Raymond S. Hartman et al., *Consumer Rationality and the Status Quo*, 106 Q. J. ECON. 141, 143–44 (1991); Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193, 197 (1991); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 8 (1988); J. Michael Collins, *You Could Lose Your Home: The Effects of State Policies Mandating Subprime Mortgage Risk Disclosures on Consumer Evaluations of Loan Offers* 13 (July 1, 2008) (unpublished manuscript), available at <http://www.ssrn.com/abstract=1505668> (“To the degree that loan applicants exhibit a bias in favor of the status quo, they will refrain from reversing a decision even when reminded of the potentially catastrophic risks by the disclosure or when given time to exert self-control.”).

<sup>173</sup> The endowment effect is illustrated by a series of experiments reported in Jack L. Knetsch, *The Endowment Effect and Evidence of Nonreversible Indifference Curves*, in CHOICES, VALUES, AND FRAMES, *supra* note 172, at 171–79. In one experiment, subjects were given a coffee mug and invited to trade it for a candy bar; 89% preferred the mug. *Id.* at 172–73. Another group of subjects was provided with a candy bar and invited to exchange it for a mug; 90% of that group preferred the candy bar. *Id.* In other words, the subjects preferred ownership of an object they had possessed momentarily over something they did not yet have. See also Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193 (1991) (additional experiments); Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1342 (1990) (“instant endowment effect”).

<sup>174</sup> See Stark & Choplin, *supra* note 165, at 102–03.

theoretically displayed in the TILA disclosure statement, in the form of monthly payments which may exceed the borrower's ability or desire to pay, but, as we have seen, those payments may be understated, are likely to be ignored, may be beyond consumers' ken, and, finally, borrowers can be persuaded to disregard them.

### *G. Attempts to Fix TILA*

In 2008, Congress amended TILA to address some of its problems.<sup>175</sup> Regulators also amended lending regulations in 2008 and 2009 and undoubtedly more such amendments are on the way.<sup>176</sup> These amendments changed both the content and the timing of the disclosures; as for the timing, until July 30, 2009 (the month our survey was conducted), disclosures were due no later than the loan closing, when they might have been lost in a mountain of forms, while now lenders are obliged to let borrowers know of changes in key loan terms at least three days before the closing.<sup>177</sup> Congress also directed the Federal Reserve to include in the disclosures for adjustable loans a "worst-case" scenario showing what the highest-possible monthly payment might be.<sup>178</sup> Changes to Regulation X, which went into effect on January 1, 2010, implementing the Real Estate Settlement Procedures Act (RESPA),<sup>179</sup> also include information about loan terms, including, on page three, for borrowers who make it that far, the maximum monthly payment.<sup>180</sup>

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<sup>175</sup> See MDIA, Pub. L. No. 110-289, 122 Stat. 2855.

<sup>176</sup> For regulations that have been promulgated, see, e.g., Truth in Lending, 73 Fed. Reg. 44,522 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226); Truth in Lending, 74 Fed. Reg. 23,289 (May 19, 2009) (to be codified at 12 C.F.R. pt. 226). The Federal Reserve has also proposed amendments to improve mortgage disclosures. See Truth in Lending, 74 Fed. Reg. 43,232 (proposed Aug. 26, 2009) (to be codified at 12 C.F.R. pt. 226).

<sup>177</sup> See 12 C.F.R. § 226.19(a)(2)(ii) (2010) (promulgated under 74 Fed. Reg. 23,289).

<sup>178</sup> 15 U.S.C.A. § 1638(b)(2)(C)(ii) (West 2010). The changes will not take effect until the earlier of the date upon which the Federal Reserve or the new CFPB promulgates regulations implementing months after July 30, 2008. See MDIA, 122 Pub. L. No. 110-289, 122 Stat. 2857. The Federal Reserve has since proposed such regulations, see Truth in Lending, 74 Fed. Reg. 43,232 (proposed Aug. 26, 2009) (to be codified at 12 C.F.R. pt. 226), and issued an interim rule to implement the MDIA, see Regulation Z, Truth in Lending, 75 Fed. Reg. 58,470 (interim rule Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226).

<sup>179</sup> Pub. L. No. 94-205, 89 Stat. 1157 (codified at 12 U.S.C. § 2601 et seq. (2006)).

<sup>180</sup> Regulation X can be found at 24 C.F.R. pt. 3500 (2010). The Settlement Statement provided at the closing, known as the HUD-1, indicates on page three whether the interest rate can rise, by how much over the life of the loan, when the first change



These are certainly improvements.<sup>181</sup> But it is not clear how effective the timing changes are, nor how effective the TILA worst-case scenario disclosure will be once it is implemented. The same consumers who did not walk away from inappropriate loans at the closing may be unwilling to cancel the transaction if they discover that the terms are not to their liking three days earlier.

Nor can we be sure that consumers will take enough time with the disclosures three days before the closing to understand them. To be sure, the changes may indeed help some consumers who learn through reading forms to understand their obligations better. Thus, the FTC Study found that improved disclosures generated improved understanding.<sup>182</sup> But even these improved disclosures had their limits: some consumers could not answer questions correctly even with the enhanced disclosures in front of them.<sup>183</sup> In addition, the FTC Study may have produced higher comprehension rates than occur in genuine transactions, as its authors noted.<sup>184</sup> Real-world borrowers face time pressures, stresses, and originators who may be unscrupulous, unlike the consumers in the study.<sup>185</sup> Interviewees in the study also resided in a more affluent, better-educated county than is typical.<sup>186</sup> All had recently

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date is, how frequently change dates occur, how much the interest rate can rise at each change date, and how much the monthly payments can rise. *See* 24 C.F.R. pt. 3500, App. A (2010).

<sup>181</sup> An early report on the new RESPA disclosures stated that “some brokers say that borrowers are asking more questions, and are very likely becoming better informed as a result, if a bit frustrated at times. Others report a mere shift in the nature of borrower confusion.” Bob Tedeschi, *New ‘Good Faith’ Takes Hold*, N.Y. TIMES, Feb. 14, 2010, at RE9.

<sup>182</sup> LACKO & PAPPALARDO, *supra* note 47, at 12.

<sup>183</sup> Even with an improved disclosure form, borrowers answered an average of 20% of the questions incorrectly, suggesting that the improved form would not solve all the problems. *Id.* at ES-7–ES-8. In some cases, the numbers were worse. “Forty-one percent of prototype form respondents, for example, could not identify the amount of prepayment penalties . . . and 30 percent did not recognize that the loan included a large balloon payment . . .” *Id.* at ES-9.

<sup>184</sup> *See id.* at 122.

<sup>185</sup> *Id.* (“These findings may be even stronger in real-world transactions. Although in real-world transactions borrowers will have greater incentive to understand loan costs, because their homes and savings are at risk, they also may face a number of factors that make it more difficult to understand their loan costs. The consumer testing was conducted in a quiet, experimental setting. Respondents did not face the time pressure of a loan closing, a large stack of other closing paperwork, or deceptive tactics aimed at obscuring loan costs, all of which are likely to aggravate the difficulties consumers have understanding their loan terms.”).

<sup>186</sup> *Id.* at 14–15.

taken out mortgages<sup>187</sup> and so were already at least partway up the mortgage learning curve. True, perhaps even better disclosures than those tested in the FTC Study might improve comprehension rates still further. But in all probability, even better disclosures will fail to address some of the problems discussed above.<sup>188</sup> Some consumers need more than written disclosures. Those who are financially illiterate will simply not learn from even perfect written disclosures, while predatory lenders seem unlikely to be defeated by mere paper disclosures no matter how wonderful or well-timed they are.<sup>189</sup> Similarly, educators have discovered that different people learn

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<sup>187</sup> LACKO & PAPPALARDO, *supra* note 47, at 14.

<sup>188</sup> See Engel & McCoy, *supra* note 72, at 1309 (“[I]ncreased disclosure is not enough because lenders will always find ways to evade disclosure requirements. Furthermore, most victims of predatory lending already find current disclosures incomprehensible. For naïve borrowers, piling on more disclosures will not help. The high-pressure nature of closings only exacerbates that confusion, by discouraging borrowers from reading loan documents at closing or asking questions when they do. Because most borrowers are not represented at closing, moreover, questions are likely to result in self-serving answers by title company officials or lenders. More disclosure would simply compound the confusion that currently exists.”); see also *Philadelphia Public Hearing*, *supra* note 61, at 26–27 (statement of Ira Goldstein, Director of Policy and Information Services, The Reinvestment Fund) (“The consensus is that financial literacy is woefully inadequate. Assuming that a written notice will overcome that, no matter how plain language that is, is plainly naïve.”); *Atlanta Public Hearing*, *supra* note 10, at 92 (statement of Ken Logan, Chairman-Elect, National Home Equity Mortgage Association) (“[I]t is our conclusion that tweaking the disclosure regimen to address only non-traditional products will not result in the fundamental issue of whether the regimen serves the purpose of effective disclosure to borrowers from a macro perspective.”); Warrington, *supra* note 120, at 147 (“Disclosures alone are not going to teach financial literacy.”).

<sup>189</sup> Predatory lenders could, for example, obscure the required disclosures by overloading the borrower with other information. Or perhaps they could convince borrowers that the worst-case scenario is improbable, and rely on the optimism bias to make that claim convincing. Or maybe they will attempt to insure that the consumer is psychologically committed to the loan before the disclosures arrive or switch from adjustable loans to those that squeeze money from borrowers in other ways. See BARR ET AL., *supra* note 48, at 6–7 (“[E]ven if meaningful disclosure rules can be created, sellers can undermine whatever before-the-fact or ex ante disclosure rule is established, in some contexts simply by ‘complying’ with it: ‘Here’s the disclosure form I’m supposed to give you, just sign here.’ . . . While an ex ante rule provides certainty to creditors, whatever gave the discloser incentives to confuse consumers remains in the face of the regulation. While officially complying with the rule, there is market pressure to find other means to avoid the salutary effects on consumer decisions that the disclosure was intended to achieve.”).

differently.<sup>190</sup> Some learn well through reading while others learn better through listening.<sup>191</sup> Congress would do better to understand that some consumers simply lack the ability to learn from written disclosures, and that such consumers require a completely different approach to understand their loans.

In sum, existing consumer protection law seems unlikely to prevent future borrowing binges of the sort that led to the 2008 economic crisis. Accordingly, the Article now explores some possible alternatives.

### III. FIXING THE PROBLEM

Obviously, the misleading disclosures described above should be fixed so that they accurately convey the consumer's payment obligations, and Congress has begun that effort.<sup>192</sup> But even if the disclosure forms had been perfect—even if, for example, lenders could accurately predict future interest rate fluctuations and so disclose at the time of closing what the borrower's future payments would be—disclosure forms that consumers ignore would still be of little value. Consequently, the Article now turns to some different approaches to the problem.

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<sup>190</sup> See Elaine Kuznar et al., *Learning Style Preferences: A Comparison of Younger and Older Adult Females*, 10 J. NUTRITION FOR THE ELDERLY 21, 22 (1991) ("Learning styles are an individual's characteristic way of processing information, feeling, and behaving in a learning situation . . .").

<sup>191</sup> See, e.g., Rita Dunn & Joanne Ingham, *Effects of Matching and Mismatching Corporate Employees' Perceptual Preferences and Instructional Strategies on Training Achievement and Attitudes*, 11 J. APPLIED BUS. RES. 30, 33 (1995) ("Employees with an auditory preference who were taught with a lecture and visuals obtained significantly higher test scores than when taught with the tactual/kinesthetic approach and visuals. . . . Employees with a tactual/kinesthetic preference who were taught with the tactual kinesthetic method produced higher (.01) test scores than when they were taught with the lecture supplemented with visuals. In addition, the mismatch of preference and method generated statistically lower test scores."); see also Sharon Marie Hoffer, *Adult Learning Styles: Auditory, Visual, and Tactual-Kinesthetic Sensory Modalities* iv (Aug. 1986) (unpublished Ph.D. dissertation, Texas A&M University), available at <http://proquest.umi.com/pqdweb?did=748689971&sid=63&Fmt=2&clientId=2945&RQT=309&VName=PQD&cfc=1> ("[A]dults do possess a dominant sensory modality through which they learn more effectively across subject matter . . .").

<sup>192</sup> See *supra* note 40 and accompanying text. For one proposal for what the disclosures should look like, see Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 153–54 (2007).

### A. Moving From a Disclosure Regime to a Comprehension Regime

TILA's ultimate goal is to enable understanding of loan terms. That understanding serves many purposes, including increasing the likelihood that consumers will act in accordance with their preferences so that credit markets will function appropriately. Indeed, if consumers understand their loan terms, it becomes less necessary for the government to proscribe objectionable loan terms.<sup>193</sup> When consumers fail to become aware of or understand loan terms, the government must intervene to bar overreaching contract terms because consumers are unable to protect themselves.<sup>194</sup> But when consumers understand loan terms, they at least theoretically have a greater ability to seek competing offers from lenders that offer better terms.

Disclosure is an intermediate step on the path to comprehension.<sup>195</sup> Consequently, if understanding is the goal, it makes sense to focus on that goal rather than an intermediate step that has proved to lead only imperfectly to comprehension and has permitted consumers to borrow unwisely.<sup>196</sup>

How can we move from a disclosure regime to a comprehension regime? Ideally, policymakers would come up with a scheme under which lenders wanted consumers to understand their loan terms. Doing so would result in those who are best able to convey loan terms to consumers having a stake in

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<sup>193</sup> Cf. Marianne A. Hilgert et al., *Household Financial Management: The Connection Between Knowledge and Behavior*, 2003 FED. RES. BULL. 309, 309 (2003), available at <http://www.federalreserve.gov/pubs/bulletin/2003/0703lead.pdf> ("Knowledgeable consumers who make informed choices are essential to an effective and efficient marketplace. In classical economics, informed consumers provide the checks and balances that keep unscrupulous sellers out of the market. For instance, consumers who know the full range of mortgage interest rates and terms in the marketplace, who understand how their credit-risk profile and personal situation fit with those rates and terms, and, consequently, who can determine which mortgage is best for them make it difficult for unfair or deceptive lenders to gain a foothold in the marketplace.").

<sup>194</sup> For example, in the Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (codified as amended at scattered sections of 15 U.S.C.A.), Congress outlawed certain provisions in credit card contracts; if consumers understood those terms and preferred alternatives, classic economic theory predicts that some credit card lenders would offer them to entice more customers, but this seems not to have happened, perhaps because consumers lacked the financial acumen to comparison-shop for such terms. See, e.g., 15 U.S.C.A. § 1666i-1 (West 2010) (limiting power of credit card issuer to increase interest rates and fees for balances).

<sup>195</sup> Cf. Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MARKETING 66, 74 (1999) ("[M]andatory disclosure of information itself does not help consumers make effective credit decisions unless they understand the information provided.").

<sup>196</sup> See BARR ET AL., *supra* note 48, at 2.

the process of communicating the relevant information. Originators are the best able to convey loan terms because they actually deal with consumers, have a measure of control over the presentation of information at the closing and before, can observe what works and what doesn't, and can then improve the methods for conveying information. One way to do this is simply to impose on lenders a requirement that borrowers understand their loan terms; that is to say, bar lenders from completing loans until they could demonstrate that a significant proportion of their borrowers understood the terms of their loans.

Doing so would cure many of the problems with TILA. First, it would shift the incentives of lenders so that they have an interest in insuring that consumers understand their payment obligations, rather than, as in some cases (like the cases involving First Alliance), obscuring those payment obligations. Second, it would get the government out of the business of deciding how to communicate to borrowers—an enterprise that the government is not the best actor to engage in, especially given that the government is not a party to the loans and does not deal directly with borrowers—and shift that burden to lenders, who are already communicating with borrowers and have considerable experience in judging how best to further that communication.

If lenders are required to care about whether consumers understand the information, they can be expected to take steps to insure that consumers are not distracted by differences between the APR and the interest rate when they receive the information and that borrowers receive the forms in a way that enables them to absorb the information the forms contain. They presumably would take as much time as is required to convey the terms, rather than devoting only a minute or less to them. In short, focusing on understanding rather than the mechanical task of supplying disclosures sharply increases the probability that the information will be understood. Lenders might respond by increasing the readability of loan forms, using the same attention-getting strategies that their marketing arms use to sell their services. They might even abandon incomprehensible terms if the cost of using such terms exceeds the benefits.

A somewhat less politically unrealistic alternative would focus on creating competition to increase the likelihood that consumers would read forms. For example, if regulators required lenders to conduct consumer testing of their forms and then publicize the results, lenders might compete for higher comprehension scores. That is to say, lenders might prefer not to disclose worse comprehension scores than their competitors, and so might increase the intelligibility of their forms. A lender might not wish to disclose that, say, half its borrowers could not understand its forms when other lenders reported that 80% of their customers understood their forms. Again,

lenders might respond not only by increasing the comprehensibility of their forms, but also by eliminating terms that borrowers could not understand.

Such a requirement might discourage lenders from lending to poorly-educated or less financially-literate borrowers—the borrowers who would benefit the most from an increased focus on comprehension, rather than disclosure. Obviously, it is not desirable to deter lenders from lending to creditworthy but unsophisticated borrowers. Accordingly, it might be necessary to devise some way of taking into account borrower sophistication in the comprehension grades to avoid this disincentive.

What kinds of terms ought to be covered by such a comprehension requirement? Essentially, any term that might materially affect the consumer's payment obligation. In identifying the relevant terms, it is best to start with a broad standard and then give examples of some such terms. The alternative—of identifying the terms that consumers should understand—risks repeating one of the problems with TILA. The original TILA disclosures were chosen at a time when most mortgages consisted of twenty- or thirty-year fixed-rate loans—so called “plain vanilla” loans. Disclosures created in such an environment were not well-suited to the far more complex products lenders created later, such as loans with fixed rates for the first two or three years, and adjustable rates thereafter, payment option ARMs, interest-only loans, or negative-amortization loans. No doubt the lack of fit between TILA's plain vanilla disclosures and the more complicated loan terms in use in the last decade contributed to the failure of consumers to understand their payment obligations. Any regime that applies to specified terms without having the flexibility to incorporate others as lending changes risks becoming outmoded by those changes. It also risks encouraging predatory lenders to create new loan products that generate excessive returns for lenders while evading consumer understanding of the products. Requiring comprehension of terms that might materially affect the consumer's payment obligation avoids those risks. But to give guidance to lenders and avoid litigation over precisely what must be disclosed, a statute should also give concrete examples of what consumers must understand.<sup>197</sup>

A comprehension regime may not work perfectly, however. First, consumers might not care about the scores, and so publication of the scores might not have any impact. It is impossible to know without some form of

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<sup>197</sup> Such examples should include, at a minimum, the current disclosures required for mortgages. See 12 C.F.R. § 226.18 (2010). The Fair Debt Collection Practices Act, 15 U.S.C. § 1692 et seq. (2006), uses a similar structure. For example, 15 U.S.C. § 1692e proscribes “false, deceptive, or misleading representations,” and also identifies in sixteen paragraphs specific practices that violate that prohibition.

testing. Second, as discussed above,<sup>198</sup> some evidence exists to indicate that even when consumers understand information, to the extent that the information conflicts with what they believe, they will not absorb and act upon it. That evidence remains to be confirmed, but if it is confirmed, to the extent that consumers would need to act on information that conflicts with their beliefs, even understanding the information might not prevent them from acting inconsistently with their best interests. In such cases, an outright ban on certain terms might be necessary.

A comprehension regime represents a dramatic departure from the current disclosure approach and is unlikely to become law anytime soon. Consequently, in Subsection B, the Article considers ways to increase the probability that consumers benefit under the existing regime.

### *B. Enhancing Understanding within a Disclosure Regime*

The purpose of this subsection is to suggest reforms that will increase the effectiveness of a disclosure regime.<sup>199</sup> In a sense, the goal is to identify strategies that lenders might adopt in a comprehension regime and then impose them on a disclosure regime. That is to say, instead of focusing solely on disclosure, policymakers might ask how a lender which genuinely wished to inform consumers of loan terms might proceed, and then select from among those possibilities choices that offer easy enforceability. Such a lender would test to verify that its strategies worked, and so the suggestions described herein should also be subjected to consumer testing—which might demonstrate that they are ineffective, in which case they should be scrapped.

Many reasons may contribute to the little attention given to TILA forms. Disclosure forms are not fun to read.<sup>200</sup> This is hardly surprising given their content and provenance. Further reducing consumer eagerness to peruse them is the fact that they must compete with other claims on consumer attention. In addition, lenders who wish to obscure unfavorable terms might affirmatively act to reduce the likelihood that consumers attend to them.<sup>201</sup> Moreover, disclosure forms present information that some consumers might not be interested in learning. To the extent that disclosure forms convey

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<sup>198</sup> See *supra* notes 92–96 and accompanying text.

<sup>199</sup> Of course, these suggestions might also help if Congress switched to a comprehension regime.

<sup>200</sup> See Omri Ben-Shahar, *The Myth of the “Opportunity to Read” in Contract Law* 1 (John M. Olin L. & Econ. Working Paper No. 415, 2008), available at <http://www.law.uchicago.edu/lawecon/index.html> (Reading standard form contracts “is boring, incomprehensible, alienating, time consuming, but most of all pointless.”).

<sup>201</sup> See *supra* notes 138–60 and accompanying text.

information that consumers might interpret as bad news, consumers might not want to take that information in. For example, adjustable-rate loan disclosure forms that communicate that monthly payments might increase to unaffordable amounts in the future might be unwelcome. Such forms also compete with the optimism bias, which empirical researchers have demonstrated causes consumers to overlook negative information, creating cognitive dissonance. Accordingly, just to get borrowers to read and take account of the information in disclosure forms might be a challenge.

Consequently, regulators must come up with a method to give consumers an incentive to read the forms, or more precisely, make consumers aware of why they have an interest in reading the forms. The book *Nudge* by Cass Sunstein and Richard Thaler describes how to change “choice architecture” so that consumers are able to make better decisions—but still retain the freedom to make those decisions—and so this section draws on their work.<sup>202</sup>

An example of such a nudge would be if applicants for credit were obliged to watch a video showing the pain default brings, applicants might be more attentive to the disclosure forms.<sup>203</sup> The video could list the cost of default and foreclosure, including late fees, collection fees, legal fees, loss of a home, the need to find a new home and the costs of moving, prepayment

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<sup>202</sup> Thaler and Sunstein describe a nudge as “any aspect of the choice architecture that alters people’s behavior in a predictable way without forbidding any options or significantly changing their economic incentives. To count as a mere nudge, the intervention must be easy and cheap to avoid.” THALER & SUNSTEIN, *supra* note 18, at 6. In their view, “people will need nudges for decisions that are difficult and rare, for which they do not get prompt feedback, and when they have trouble translating aspects of the situation into terms that they can easily understand.” *Id.* at 72. That seems to describe mortgage borrowing fairly well.

<sup>203</sup> Cf. *Atlanta Public Hearing*, *supra* note 10, at 148–49, 168 (statement of Vanessa Gail Perry, George Washington University School of Business) (“Consumers will be motivated to attend to and to process disclosure information if the information is personally relevant. That is, the information pertains to the specifics of their financial—their financial situation. In addition, consumers will be motivated to utilize disclosure information if they perceive a high level of risk in the transaction. Consumers will perceive a higher degree of risk if the communication suggests that substantial financial, social, or other interests are at stake. . . . So how do we motivate consumers to use disclosure information? One way is to introduce disclosure information with personally relevant statements that communicate risk information. The statements that introduce the disclosure of specific terms may be as important as the terms themselves. For example, with this loan you will owe more than you do now, and you may face higher monthly payments as a sort of introductory statement. . . . [I]f you start out by sort of scaring them, that is, with some negative information and then you allow the consumer to control the flow of information, what you’ve done is give them the information and give them a reason to sort of take steps on their own to read the fine print or go to another part of the disclosure.”).



penalties (if the borrower is able to sell the home), damage to the consumer's credit rating, loss of whatever equity the consumer had in the home, and the possibility of loss of other assets in states that permit lenders to satisfy deficiencies out of such assets. Families can suffer severe disruptions, ending up homeless, living in tent cities, or in overcrowded quarters.<sup>204</sup>

The video could explain the emotional toll of foreclosure. According to Dr. Robert Gifford, an environmental psychologist, foreclosure can be "deeply traumatic."<sup>205</sup> Gifford claims that it undermines "a key part of well-being: perceived control over your life."<sup>206</sup> Gifford adds that when people lose their home, "It's like their planet blew up."<sup>207</sup> Clinical psychologist Rosalind Dorlen reports that losing a home can cause depression and anxiety.<sup>208</sup>

Anecdotal reports in the media may make the point more salient for borrowers. For example, Bob Herbert of the New York Times described one borrower's experiences:

Dorothy Levey, a 79-year-old widow . . . sits alone inside the small house she has lived in for 41 years, afraid to answer the telephone or the door.

She has every reason to be worried. The monthly note on her house in the city of Markham, just outside Chicago, is approximately 100 percent of her meager monthly income. Broke and behind in her payments, Ms. Levey expects a foreclosure notice to show up any day, followed by a visit from "the sheriff, or whoever they send to tell you to get out of your own home". . . .

. . . .

. . . [S]he kept trying to meet her obligation. She exhausted her savings. She lost her car. She stopped buying clothes and cut back on food. But there was no way to keep up with the payments.

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<sup>204</sup> Julie Scelfo, *After the House is Gone*, N.Y. TIMES, Oct. 23, 2008, at D1 (describing how a family, after abandoning its home, sleeps six to a bed and seven in a room).

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*; see also IMMERGLUCK, *supra* note 86, at 147 ("[F]inancial stressors such as mortgage delinquency and default are thought to trigger anxiety, depression, and addictive behaviors.").

"I had to go to the state and tell them I was hungry," she said.<sup>209</sup>

But the video should not explain only the costs of foreclosure. It could also make the risks of the wrong type of loan terms more salient for consumers. For example, the video could explain that adjustable-rate loans may bring with them future increases in payments, and the possibility that housing prices would not increase sufficiently to permit refinancing. The goal would be to increase the likelihood that borrowers would take such risks into account in their planning. And the video should itself be tested to determine whether it has the desired effect; if it doesn't, it should be modified so that it does, or be replaced by another strategy.

Nudges can also be used to cause consumers to attend to particularly problematic contract clauses.<sup>210</sup> For example, if terms associated with an increased risk of foreclosure—such as hybrid ARMs, prepayment penalties and balloon payments—included bold-print legends such as, "This term may cause you to lose your home," consumers might be more likely to explore other options.<sup>211</sup> A note indicating the percentage of borrowers in a recent

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<sup>209</sup> Herbert, Editorial, *Lost in a Flood of Debt*, *supra* note 52; *see also* Herbert, Editorial, *A Swarm of Swindlers*, *supra* note 52 ("[Another borrower] told me her story in the freezing living room of the house on Merrill Avenue, which no longer has a working furnace and is growing shabbier by the day. It's all she has left. Her mother and her older sister are dead now. Her only income is about \$1,300 a month from Social Security—less than the monthly note on the house, which is in foreclosure proceedings. . . . 'I'm terrified,' Ms. Dailey told me as she wrapped a sweater tightly around her to ward off the cold. 'I can't sleep anymore. They're trying to take the house away from me, and I wanted to stay here until I died. That was what I was really trying to do.' . . . I asked Rosa Dailey yesterday how she'd be spending her Thanksgiving. She said her money for the month had run out, so she wouldn't be doing anything special. . . . 'I'll be right here,' she said. 'I've got some corn flakes and canned vegetables. That'll be my Thanksgiving.'").

<sup>210</sup> *Cf.* Collins, *supra* note 172, at 22 ("[T]his analysis [of high-cost refinance loans] suggests that state laws requiring mortgage applicants to sign a disclosure warning 'you could lose your home' result in a greater likelihood that consumers will reject an approved high-cost refinance loan offer from a lender."); Erik F. Gerding, *The Subprime Crisis and the Link Between Consumer Financial Protection and Systemic Risk* 22 (May 28, 2009) (unpublished manuscript), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1291722](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1291722) (published version of article available at 4 FLA. INTL. U. L. REV. 435 (2009), but does not include quoted passage) ("To ensure that consumers mentally process the disclosure, regulations could require that consumers copy important disclosure passages in their own handwriting. Additional opt-in provisions and disclosure could be required for consumers to be bound by more complex floating rate provisions.").

<sup>211</sup> *See* SCHLOEMER ET AL., *supra* note 10, at 5, 21 (noting that terms that increase risk of foreclosure "include adjustable interest rates, balloon payments, prepayment penalties, and loans with limited documentation of borrowers' loan qualifications" and

year who defaulted on loans containing such terms might also generate more attention.<sup>212</sup>

Another step is to require consumers to draft a budget that brings home to them how much (or little) money they will have available after meeting their housing expenses under the loan. The act of constructing a budget should force the applicant to read the form and increase the likelihood that she masters its contents. In addition, with loans that offer the possibility of future increases in monthly payments, the applicant should be obliged to prepare budgets for future years on the assumption that the monthly payments have increased to their maximum level.<sup>213</sup> Doing so should help the consumer understand the worst-case scenario and the risks the borrower

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reporting that the foreclosure risk of ARMs is 62 to 123% higher than fixed-rate mortgages, balloon payments increase the risk by 14 to 86%, and low- or no-documentation loans carry a 5 to 64% greater risk); *see also* Roberto G. Quercia et al., *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments* 1, 25 (Jan. 25, 2005) (unpublished manuscript), *available at* <http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.120.4308> (“We find that [prepayment penalties and balloon-payment requirements] lead to a significant increase in mortgage foreclosure risk, even after controlling for other risk factors. For instance, refinance loans with prepayment penalties and those with balloon payments are more likely to experience a foreclosure than loans without these characteristics—by about 20 percent and 50 percent, respectively. . . . [W]e estimate that the use of prepayment penalties and balloon payment requirements in 1999 refinance originations increased foreclosure-related losses by about \$465 and \$127 million nationally, respectively. . . . [A]djustable-rate mortgages have 50 percent greater odds of foreclosure than fixed-rate loans.”). Others have identified the mandatory arbitration clause as a clause that creates difficulties for borrowers, because it may make class-action suits prohibitively expensive. *See* GRAMLICH, *supra* note 78, at 67.

<sup>212</sup> Barr et al. suggest what the authors call an *ex post* standards-based disclosure requirement that asks “whether the disclosure would have, under common understanding, effectively communicated the key terms of the mortgage to the typical borrower.” BARR ET AL., *supra* note 48, at 7. This approach differs from the one suggested herein in that this paper focuses on the subjective understanding of the actual borrower while the Barr et al. paper looks to whether a reasonable consumer would have understood the major loan terms.

<sup>213</sup> Oren Bar-Gill has argued that “ensuring robust competition in the subprime mortgage market [will] not solve the problem” of borrowers taking out loans that provide for low initial rates and excessive payments later in the life of the loan because some borrowers irrationally prefer such loans and lenders eager to make loans will accommodate such preferences. *See* Bar-Gill, *supra* note 68, at 1083–84 (citation omitted). My hope is that the kind of nudges this paper suggests will counteract that tendency.

is taking that he will run short of funds and lose the home.<sup>214</sup> Presumably the Countrywide borrowers who took out loans that would reset at unaffordable levels within two or three years would have been less eager to do so if they had understood what they were risking.

An example may bring home the value of constructing a budget. In 2006, a Government Accountability Office report on alternative mortgage products explored the problem of “payment shock” on a \$400,000 payment-option adjustable-rate mortgage.<sup>215</sup> Assuming rising interest rates, a borrower who made only the minimum monthly payments on the loan would experience a 128% increase in payments after five years, from \$1,287 to \$2,931.<sup>216</sup> As Vincent DiLorenzo has observed, “Many borrowers would be unable to pay the higher payments required of them, particularly if their ability to repay was based on the low initial interest rate.”<sup>217</sup> But until the borrower constructs a budget, the borrower may not realize that. Creation of a budget would force the borrower to contemplate what changes the borrower would make in her other expenditures in response to such a jump, and consequently whether the loan is unaffordable.

The importance of creating a budget is also emphasized by the fact that nearly a third of United States homeowners are thought to live in unaffordable housing, and more than a tenth have severely unaffordable housing.<sup>218</sup> Preparation of a budget might have brought home to these homeowners how such large housing expenditures would impair their ability to meet other expenses.

Preparing a budget—indeed, even understanding the disclosure forms—will nevertheless be beyond some loan applicants. Some borrowers are financially illiterate.<sup>219</sup> But these borrowers should not be barred from borrowing if they are able to meet their obligations. They may require a neutral credit counselor—not a mortgage broker who benefits from securing

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<sup>214</sup> Cf. McCoy, *supra* note 192, at 147 (“[I]t is essential that all borrowers, including subprime borrowers, understand the worst case payment scenario before they take out I-O and option ARMs.”).

<sup>215</sup> See GAO: ALTERNATIVE MORTGAGE PRODUCTS, *supra* note 10, at 4–5 (statement of Orice M. Williams, Director Financial Markets and Community Investment, U.S. Government Accountability Office).

<sup>216</sup> *Id.* The GAO assumed “a 1 percent initial interest rate, a 7.5 percent annual payment increase cap, and a 10 percent negative amortization cap.” *Id.* at 5 n.2.

<sup>217</sup> DiLorenzo, *supra* note 20, at 38. But see Mayer et al., *supra* note 21, at 37 (“[T]he distinguishing feature of the short-term hybrid mortgage—the change in the mortgage rate two or three years after origination—does not seem to be strongly associated with increased defaults . . .”).

<sup>218</sup> See *supra* note 82 and accompanying text.

<sup>219</sup> See *supra* note 97 and accompanying text.

them a loan—to advise them.<sup>220</sup> Several studies have demonstrated the efficacy of counseling for the populations studied.<sup>221</sup> An experiment in Chicago provides additional guidance. Chicago required residents with certain credit scores living in ten of its zip codes who sought high-risk mortgages to submit to credit counseling.<sup>222</sup> Here is how one study characterized the results:

[C]ounseled borrowers pay similar interest rates to non-counseled borrowers . . . nevertheless, their leverage ratio is slightly lower, on average. Importantly, loans originated by counseled borrowers during the treatment period experienced markedly lower ex post default rates. These results hold after controlling for improvements in the credit quality of the borrower pool and for changes in the composition of the pool of available lenders. . . . On the other hand, counseling did not appear to cause the

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<sup>220</sup> FTC Workshop, *supra* note 44, at 171 (“[A] benevolent smart agent can arrange a better choice context.”); Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 198 (2008) (“Consumers generally do not serve as their own doctors and lawyers and for reasons of efficient division of labor alone, generally should not serve as their own financial experts.”).

<sup>221</sup> See Abdighani Hiram & Peter Zorn, *Prepurchase Homeownership Counseling: A Little Knowledge Is a Good Thing*, in LOW INCOME HOMEOWNERSHIP: EXAMINING THE UNEXAMINED GOAL 146, 146–47 (Nicolas P. Retsinas & Eric S. Belsky eds., 2002) (“We find statistical evidence that counseling does, in fact, mitigate credit risk. Borrowers who receive prepurchase homeownership counseling under the [program studied] are, on average, 19 percent less likely to become ninety-day delinquent on their mortgages than borrowers with equivalent observable characteristics who do not receive counseling. . . . All things equal, the ninety-day delinquency rate of borrowers who received individual counseling was reduced by 34 percent . . . .”); Valentina Hartarska & Claudio Gonzalez-Vega, *Evidence on the Effect of Credit Counseling on Mortgage Loan Default by Low-Income Households*, 15 J. HOUSING ECON. 63, 63 (2006) (“We find some evidence that counseled borrowers defaulted less often than non-counseled borrowers . . . .”); Valentina Hartarska et al., *supra* note 13, at iii (“Our findings indicate that cash flow-based counseling can decrease the incidence of default. Counseled borrowers exhibit one-half the hazard rate of default of non-counseled borrowers. The positive impact of counseling most likely emerges from the more accurate measurement of repayment capacity that results from the counseling process and from the abandonment of rigid income-to-debt ratios in screening potential borrowers.”); see also Roberto G. Quercia et al., *The Cost-Effectiveness of Community-Based Foreclosure Prevention* 35 (Dec. 8, 2005) (unpublished manuscript), available at [http://www.fhfund.org/\\_dnld/reports/MFP\\_Full-Report.pdf](http://www.fhfund.org/_dnld/reports/MFP_Full-Report.pdf) (borrowers who received pre-purchase counseling are more likely to avoid foreclosure).

<sup>222</sup> The program was instituted under the authority of 765 ILL. COMP. STAT. § 77/70 et seq. (West 2010), and is commonly known as H.B. 4050.

lowest-credit-quality borrowers to avoid the more 'exotic' mortgage products: adjustable rate and interest only.<sup>223</sup>

Another review found the counseling "helped borrowers better understand the costs and terms of their loans, leading to better-informed decision-making."<sup>224</sup> Tellingly, the same review found that "[m]ore than half of the borrowers referred for [counseling] could not afford the loan they were being given by their mortgage broker/loan originator"<sup>225</sup> while 38% of the borrowers had been given loans with debt-to-income ratios exceeding half their income.<sup>226</sup>

It thus appears that credit counseling offers hope of reducing defaults and reducing the use of onerous terms.<sup>227</sup> Credit counselors can also counter the

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<sup>223</sup> Sumit Agarwal et al., Can Mandated Financial Counseling Improve Mortgage Decision-Making? Evidence from a Natural Experiment 3-4 (Feb. 2009) (unpublished manuscript), *available* at <http://management.ucsd.edu/faculty/seminars/2009/papers/david.pdf>. The authors also concluded "that mandatory counseling limited both the demand for new mortgages and the supply of credit, and hampered real-estate market activity in the treated areas." *Id.* at 3.

<sup>224</sup> ILL. DEP'T FIN. AND PROF'L REGULATION, *supra* note 10, at 1.

<sup>225</sup> *Id.* The definition of "unaffordable" was a ratio of debt to income of more than 45%. *Id.* at 2. In contrast, the Department of Housing and Urban Development standard is 30%. *See supra* note 81 and accompanying text.

<sup>226</sup> ILL. DEP'T FIN. AND PROF'L REGULATION, *supra* note 10, at 3. In only 12% of the cases were no issues found with the loan. *Id.* "'No Issues' meant that the information entered by the Loan Originator matched the information verified by the HUD-certified Counseling Agency; there were no indicia of fraud; that the borrower appeared to understand the transaction; that the loan had a 'market rate'; and that it was 'affordable.'" *Id.* The agencies also found that 22% of the loan rates exceeded the market rate, which the agencies defined as exceeding 9.186% when fixed rates were no more than 6.4%. *Id.*

<sup>227</sup> *See Stark & Choplin, supra* note 165, at 85 (calling for counseling in some circumstances). But counselors may not be a perfect solution. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-606, REVERSE MORTGAGES: PRODUCT COMPLEXITY AND CONSUMER PROTECTION ISSUES UNDERSCORE NEED FOR IMPROVED CONTROLS OVER COUNSELING FOR BORROWERS 2 (2009) ("GAO's undercover participation in 15 . . . counseling sessions found that while the counselors generally conveyed accurate and useful information, none of the counselors covered all of the topics required by HUD . . ."); GAO: CONSUMER PROTECTION, *supra* note 107, at 95 ("[C]ounseling may be ineffective against lenders and brokers that engage in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents. Finally, the quality of mortgage counseling can vary because of a number of factors. For example, one federal official cited an instance of a mortgage company conducting only cursory telephone counseling in order to comply with mandatory counseling requirements."). Accordingly, at a minimum, it would be necessary to have rigorous training and oversight for counselors.

claims of predatory lenders, and draw consumers' attention to matters lenders like First Alliance might prefer they overlook.<sup>228</sup> But credit counselors cost money, and it seems pointless to require those who don't need a credit counselor to spend that money. Consequently, some measure should be taken to distinguish those who need a counselor from those who can understand the disclosures without one. Regulators should take a page from college placement exams and require borrowers who wish to avoid retaining a credit counselor to demonstrate understanding of their loan terms and budget by requiring them to take a test: those who pass can dispense with a credit counselor, though of course they would always be free to retain one, while those who fail should not be permitted to borrow until a credit counselor certifies that they understand the loan terms and the consequences those terms will have for them. The "placement test" should include questions drawn from the video—to insure that the borrower understands the consequences of poor decision making—the specific loan terms the borrower is contemplating assuming, and the effect those terms may have on the borrower's budget—to insure that the borrower fully appreciates the significance of her decision.

At the end of the day, however, disclosure is not a complete remedy. Some terms may be too complex to be conveyed to ordinary consumers. Consumers may simply refuse to believe others.<sup>229</sup> Accordingly, as Federal Reserve Chairman Ben S. Bernanke has noted, "In those cases, direct regulation, including the prohibition of certain practices, may be the only way to provide appropriate protections."<sup>230</sup>

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<sup>228</sup> See Willis, *supra* note 220, at 269 ("Affordable expert advice provided through a publicly funded, accessible system of neutral, financially trained intermediaries, akin to pro bono legal advice, could equalize the positions of consumers and sellers and reduce consumer anxiety about financial decisions.").

<sup>229</sup> See *supra* notes 92–95 and accompanying text.

<sup>230</sup> Ben S. Bernanke, Chairman, Fed. Reserve Bd., Address at the Federal Reserve System's Biennial Community Affairs Research Conference (Apr. 17, 2009), *transcript available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>; see also Truth in Lending, 73 Fed. Reg. 44,524 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) ("Limitations on price and product transparency in the subprime market—often compounded by misleading or inaccurate advertising—may make it harder for consumers to protect themselves from abusive or unaffordable loans, even with the best disclosures."); GOLDSTEIN, *supra* note 47, at 68 ("Notices can be made better and consumers more knowledgeable through education and counseling. Those alone will not amply protect consumers.").

### C. The Paternalism Argument

These measures are unquestionably paternalistic. They will bar some consumers from borrowing at the moment when they wish to, though the borrowers may later be able to obtain a loan. They require borrowers to satisfy additional requirements, such as taking a test and viewing a video, in what is already a time-consuming and tiresome process.<sup>231</sup> Borrowers who already fully understand the risks of borrowing and understand their loan terms will be required to demonstrate that fact, thereby incurring costs and delays that do not benefit them. Not only do such delays postpone borrowers' ability to move into a new home, they may also increase the cost of locking in interest rates.<sup>232</sup> How can this be justified in a private transaction, such as that between lender and borrower?

The answer is that the transaction is not truly private. Society has a stake in avoiding foreclosures. The subprime crisis precipitated the worst economic decline since the Great Depression, one that some claim is itself a lesser depression,<sup>233</sup> and has earned the sobriquet "the Great Recession." According to the Center for Responsible Lending, subprime foreclosures in 2009 alone will cause more than 69.5 million nearby homes to decline in price an average of \$7,200, producing a \$502 billion drop in property values.<sup>234</sup> Dan Immergluck and Geoff Smith cataloged some of the costs

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<sup>231</sup> Opinions differ as to whether the Chicago mandatory counseling program caused delays. Compare ILL. DEP'T FIN. AND PROF'L REGULATION, *supra* note 10, at 2 ("There were no documented delays in the closing of loans because of a lack of counselors or delays in providing the [counseling]. From this perspective, HB 4050 had no adverse effect on either the mortgage lending or real estate sales processes."), with Lisa K. Bates & Shannon Van Zandt, Illinois' New Approach to Regulating Predatory Lending: Unintended Consequences of Borrower Triggers and Spatial Targeting 23 (Univ. of Ill. Spatial Pol'y Analysis Research Consortium, Working Paper No. 2007-02, 2007), available at [http://www.ace.illinois.edu/Reap/SPARC/2007-02\\_BatesVanzandt.pdf](http://www.ace.illinois.edu/Reap/SPARC/2007-02_BatesVanzandt.pdf) ("While the [counseling] process is intended to take less than two weeks, the borrowers' interest rate lock period may pass 30 days due to difficulty in scheduling . . .").

<sup>232</sup> See Bates & Van Zandt, *supra* note 231, at 23.

<sup>233</sup> See, e.g., RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION, at vii-ix (2009).

<sup>234</sup> SOARING SPILLOVER, *supra* note 7, at 1; see also *Neighborhoods: The Blameless Victims of the Subprime Mortgage Crisis: Hearing Before the Subcomm. on Domestic Policy of the H. Comm. on Oversight and Government Reform*, 110th Cong. 34-35, 41 (2008) (testimony of Vicki Been, Elihu Root Professor of Law, New York University) (also finding that foreclosures reduce value of nearby properties, though less so than the Center for Responsible Lending study, and noting, "Our research shows that the foreclosure crisis is affecting not just the homeowners who are unable to pay their



foreclosures impose on communities: "Foreclosures, particularly in lower-income neighborhoods, can lead to vacant, boarded-up, or abandoned properties. These properties, in turn, contribute to physical disorder in a community, create a haven for criminal activity, discourage the formation of social capital, and lead to further disinvestment."<sup>235</sup> And William C. Apgar and Mark Duda explained: "Foreclosures are not only expensive to borrowers and lenders, but [in Chicago] they involve more than a dozen agencies and twice as many specific municipal activities, and generate direct municipal costs that in some cases exceed \$30,000 per property."<sup>236</sup> The lost

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mortgages, but also is imposing significant costs upon the neighbors and tenants of those owners, as well as the communities in which the properties going into foreclosure lie.").

<sup>235</sup> Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 57 (2006) ("Our most conservative estimates indicate that each conventional foreclosure within an eighth of a mile of a single-family home results in a decline of 0.9% in value."); see also Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851, 863 (2006) ("This study finds that higher neighborhood foreclosure rates lead to higher levels of violent crime at appreciable levels."); ESSENE & APGAR, *supra* note 68, at 2 ("[F]oreclosed properties can remain vacant for a prolonged period of time, depressing property values and contributing to neighborhood instability and stigma.").

<sup>236</sup> WILLIAM C. APGAR & MARK DUDA, HOMEOWNERSHIP PRESERVATION FOUND., COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY'S MORTGAGE FORECLOSURE BOOM 4 (2005), available at [http://www.995hope.org/content/pdf/Apgar\\_Duda\\_Study\\_Short\\_Version.pdf](http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf). The authors expounded:

For municipalities, foreclosures trigger significant direct expenditures for increased policing and fire suppression, demolition contracts, building inspections, legal fees, and expenses associated with managing the foreclosure process (e.g., recordkeeping/updating). Police officials interviewed for this study also cited the damage to quality of life from empty, foreclosed properties, including gang activity, drug dealing, prostitution, arson, rape, and murder. Even after the foreclosure process is completed, costs continue to accrue in cases where the municipality inherits responsibility for securing and/or demolishing the unit, clearing trash from the lot, and keeping weeds under control.

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When foreclosure leads to demolition, the municipality faces additional property tax losses because it must remove the assessed value of the structure from its tax roles [sic]. Municipal revenues are also reduced by delayed and uncollected taxes and unpaid service fees for water, gas, and electricity. More generally, to the extent that foreclosures make urban neighborhoods less attractive to households and businesses, municipal sales and income tax receipts also suffer.

....

jobs, lost wealth, shuttered businesses, damaged communities, and general decline in societal well-being means that society has an interest in preventing repetitions of the behavior that led to the economic slide. In recognition of that interest, Congress has enacted a series of statutes designed either to ameliorate the severity of the slump or prevent its repetition.<sup>237</sup> In that light, paternalistic legislation seems justified.

In addition, most of the suggested interventions are only marginally paternalistic; indeed, they constitute examples of what Thaler and Sunstein call “libertarian paternalism”—an intervention that does not bar the consumer from pursuing his desired action but helps the consumer make a better decision.<sup>238</sup> Alternatively, the interventions could be justified as “asymmetric paternalism,” which has been defined as an approach that “creates large benefits for those who make errors, while imposing little or no harm on those who are fully rational.”<sup>239</sup> Thus, those who can pass the test can avoid much delay and expense, while those who cannot would derive large benefits from taking the test.

Critics of the Chicago counseling program complained that it was racist.<sup>240</sup> But that seems to have more to do with the fact that the program, a pilot program, was confined to area codes that were disproportionately populated by people of color.<sup>241</sup> A program that was not so confined should not be subject to such concerns.

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Complicating matters is the fact that nonprime foreclosures tend to cluster in ways that generate significant spillover effects as vacant properties become magnets for crime and other social ills. In fact, extreme rates of loan failure suggest that foreclosures are “contagious,” with one loan failure increasing the likelihood of another.

*Id.* at 6, 7, 9.

<sup>237</sup> See, e.g., Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008) (codified as amended at scattered titles and sections of the United States Code).

<sup>238</sup> See THALER & SUNSTEIN, *supra* note 18, at 4–6. Some of the measures suggested in this paper, like banning contract terms that consumers cannot understand or barring borrowers from taking out loans if they do not understand the terms, however, go beyond libertarian paternalism.

<sup>239</sup> Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism,”* 151 U. PA. L. REV. 1211, 1212 (2003).

<sup>240</sup> See Agarwal et al., *supra* note 223, at 7 (footnote omitted).

<sup>241</sup> See *id.*

### D. Cost

The measures suggested above will increase the cost of borrowing and slow it down.<sup>242</sup> This subsection argues that those costs are worth incurring.

The video may be costly to create, but once it is created, the marginal cost of showing it to additional borrowers is trivial. When the cost of the video is amortized over millions of loan applicants, it seems likely to add only an insignificant amount to each individual loan.

Perhaps the most costly suggested intervention, in terms of out-of-pocket costs, is the credit counseling. The Chicago ordinance mandated a \$300 charge, which was to be paid by the mortgage originator.<sup>243</sup> Those receiving counseling must invest time, disclose their financial circumstances, and, if they later litigate against the lender for, say, unconscionability, may encounter greater difficulty in claiming that they did not understand their loan terms.<sup>244</sup> But probably many borrowers will be able to “place out” of the credit counseling. In addition, Congress does not seem to find the cost of credit counseling too daunting, because it has already required credit counseling in other contexts. Thus, consumers filing for bankruptcy, even if represented by attorneys, must demonstrate that they have received

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<sup>242</sup> Cf. Zywicki & Adamson, *supra* note 2, at 4 (“Heightened protections for borrowers that increase the cost or risk of lending will raise the cost of lending and result in either higher interest rates for borrowers or reduced access to credit.”). The Chicago program led to differing views about the effect of mandatory counseling on access to credit. Compare ILL. DEP’T FIN. AND PROF’L REGULATION, *supra* note 10, at 1 (“Counseling agencies did not find that HB 4050 limited borrowers’ access to credit within the Pilot Program Area or that the Pilot Program Area was considered unattractive to new homebuyers. More than 300 different Illinois mortgage licensees originated loans for borrowers in the Pilot Program Area during the Pilot Phase.”), with Bates & Van Zandt, *supra* note 231, at 5 (“Several lenders suspended lending in the targeted areas, citing concerns about liability.”).

<sup>243</sup> See 765 ILL. COMP. STAT. § 77/70(d) (West 2010); Agarwal et al., *supra* note 223, at 6. Another study reported what it described as “very approximate information on the average costs of providing housing counseling services.” CHRISTOPHER E. HERBERT ET AL., U.S. DEP’T OF HOUSING AND URBAN DEV., OFFICE OF POL’Y DEV. AND RESEARCH, THE STATE OF THE HOUSING COUNSELING INDUSTRY xii (2008), available at <http://ssrn.com/abstract=1341050>. The authors further reported:

About half of all agencies have average costs per client of around \$200 or less, another third have average costs between \$200 and \$500, and about one-fifth have average costs of more than \$500. However, 10 percent of agencies have average costs of more than \$1,000 per client, resulting in a high average across all agencies (\$431) compared to the median (\$225).

*Id.*

<sup>244</sup> Agarwal et al., *supra* note 223, at 6.

counseling.<sup>245</sup> Before emerging from bankruptcy, debtors must undergo still more counseling, in the hope that they will learn to avoid the behavior that caused them financial difficulties.<sup>246</sup> If the cost of counseling is worth imposing not just once, but twice, on those who have the least resources, it is surely worth requiring for those whose financial circumstances are strong enough for them to obtain credit and who risk failures that might impose significant costs on society, not to mention themselves. Nor is required counseling limited to bankruptcy. Fannie Mae and Freddie Mac require homeownership education, with a financial focus, for some of their affordable mortgage programs.<sup>247</sup> Some state anti-predatory lending statutes require credit counseling.<sup>248</sup> And applicants for reverse mortgages must get counseling.<sup>249</sup>

Even if the cost is significant—and it probably will not be—that cost pales in comparison to the cost the subprime fiasco has imposed on society.<sup>250</sup> The cost of ex ante comprehension is also likely to be less than the cost of ex post litigation that might stem from some alternative suggestions for addressing the problem, such as imposition of a fiduciary duty on mortgage originators or a requirement that lenders offer only loans suitable for the particular borrower.<sup>251</sup>

If the program is successful, it is likely to reduce the number of consumers who take out loans. That in turn may reduce the demand for

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<sup>245</sup> See 11 U.S.C. § 109(h) (2006).

<sup>246</sup> See 11 U.S.C. §§ 727(a)(11), 1328(g)(1) (2006).

<sup>247</sup> See, e.g., FANNIE MAE, *Home-Buyer Education Policies*, <https://www.efanniemae.com/is/hcounselors/homebuyered.jsp> (last visited Aug. 23, 2010); FREDDIE MAC, *Home Possible Mortgages Homeownership Education Requirements*, [http://www.freddiemac.com/sell/factsheets/pdf/home\\_possible\\_education\\_requirements\\_748.pdf](http://www.freddiemac.com/sell/factsheets/pdf/home_possible_education_requirements_748.pdf) (last visited Aug. 23, 2010).

<sup>248</sup> See, e.g., N.C. GEN. STAT. § 24-1.1E(c)(1) (2010).

<sup>249</sup> See 24 C.F.R. § 206.41(a) (2010).

<sup>250</sup> Robert J. Shiller, *How About a Stimulus for Financial Advice?*, N.Y. TIMES, Jan. 18, 2009, at B5, argues for “starting a major program to subsidize personal financial advice for everyone.” See also Willis, *supra* note 220, at 269 (“Affordable expert advice [could be] provided through a publicly funded, accessible system of neutral, financially trained intermediaries . . .” (footnotes omitted)).

<sup>251</sup> See Bar-Gill & Warren, *supra* note 39, at 98 (“The regulation of consumer credit markets is not amenable to ex post judicial review.”). For proposals for imposition of a suitability standard, see, e.g., Engel & McCoy, *supra* note 72, at 1318; Daniel S. Enhrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUS. & CMTY. DEV. L. 117, 125–26 (2001); GOLDSTEIN, *supra* note 47, at 68. I have no serious quarrel with such suggestions, however.

purchasing homes, with numerous consequences for the economy. Some reports suggest that the Chicago pilot project reduced home sales.<sup>252</sup> But the events of 2008–09 suggest that that is no cost at all. If consumers would not want loans if they were better informed, they should be given the tools to discover that fact. Society would be far better off today if more of the consumers who ended up in foreclosure had made such a judgment. Even the purported benefit of lending to subprime borrowers—increasing homeownership and creating an “ownership society”—has been a chimera. According to the Center for Responsible Lending, subprime lending has actually produced a drop in homeownership in light of the mountain of foreclosures.<sup>253</sup> Similarly, while lenders may make fewer loans under the reforms suggested in this Article, that seems better than having them make the kinds of loans they made that triggered the economic crisis: loans that ended up in foreclosure, and forced many lenders into bankruptcy.<sup>254</sup>

An arguable cost of the approach suggested herein is that it would discourage lenders from using incomprehensible terms that benefit borrowers. It is not clear, however, that terms that are both incomprehensible and beneficial to consumers exist. Barring the use of unintelligible terms might also raise the cost to lenders of developing new loan products, because any such products that increase term complexity might be more difficult to explain to consumers. But the loss of such products might not actually be a problem. In hindsight, the complexity of subprime loans was one of their drawbacks. Complexity has significant costs, including impairing comparison shopping, because complex loans are less easily compared to

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<sup>252</sup> Bates & Van Zandt, *supra* note 231 at 5–6 (“[A] preliminary analysis of sales data [shows] that borrower-triggered interventions are having a dramatic negative effect on housing sales . . . .”); Lesley R. Chinn, *Critics: HB 4050 is an Invasion of Privacy*, CHI. WEEKEND, Nov. 8, 2006, available at ProQuest (realtor attributed 80% decline in sales to HB 4050).

<sup>253</sup> CTR. FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 2 (2007), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Net-Drain-in-Home-Ownership.pdf> (“Subprime loans made during 1998–2006 have led or will lead to a net loss of homeownership for almost one million families. In fact, a net homeownership loss occurs in subprime loans made in every one of the past nine years.” (footnote omitted)); see also DiLorenzo, *supra* note 20, at 53 (“[T]he evidence has actually revealed that there were no net societal benefits in the form of increased levels of homeownership in the long-term.”).

<sup>254</sup> Cf. Camerer et al., *supra* note 239, at 1220–21 (“[W]e claim that any asymmetrically paternalistic policy that helps boundedly rational consumers make better choices must, on net, increase economic efficiency as measured by the sum of consumer and producer surplus. . . . To the extent that [asymmetric paternalistic] policies succeed, they will result in superior social outcomes even if individual firms are hurt. However, it is not necessarily the case that firms will be hurt . . . .”).

other loans, and it may be that any term that consumers cannot understand simply comes at too dear a price. And complexity need not mean incomprehensibility: if all the parties to a loan wish borrowers to understand particular loan terms, surely a way can be found to achieve that goal.

### E. *The First Assumption*

This Article noted at the outset that it is based on an assumption that consumers will not knowingly assume obligations that they cannot discharge, and therefore better consumer protections of the sort suggested in this Article could have prevented the economic crisis. Some have challenged that assumption.<sup>255</sup> The assumption is probably accurate as to some consumers but not as to others, but in truth, the assumption remains largely untested. The assumption finds some support in evidence that borrowers are more likely to spurn higher-priced loans.<sup>256</sup> While it is impossible to know precisely what it is about the loans that prompts higher rejection rates, perhaps among the factors is that borrowers find them more likely to generate defaults.

If circumstances had been different, the subprime crisis might have presented one test of the assumption: perhaps informed borrowers would have been willing to take on loans which they would find unaffordable at some point in the future if they were confident in their ability to refinance. Some consumers seemingly were persuaded to take out mortgages by claims that they would be able to refinance before the loans adjusted to a higher rate. The theory was that real estate prices would rise, thereby giving borrowers increased equity in their homes. They could then refinance at a lower rate because the increased equity would reduce the lender's risk. Lenders found the prospect of short-term refinancing attractive because it enabled them to obtain additional fees within a fairly short period, especially for loans that provided for prepayment penalties.

But it is not clear that this is what happened. Considerable evidence suggests that borrowers did not understand their loan obligations<sup>257</sup> and so

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<sup>255</sup> See FTC Workshop, *supra* note 44, at 147–48 (statement of Paul Willen, Federal Reserve Bank of Boston) (“[M]ore or better disclosures about the mortgage itself would not have helped that much because it is not the mortgages that are the problem, it is the house prices. . . . In terms of households making the right decision they needed not just an understanding of the mortgage itself, but a broader understanding of the risks of home ownership including house prices and, in particular, house prices.”).

<sup>256</sup> See WOODWARD, STUDY OF CLOSING COSTS, *supra* note 75, at 77 (reporting that lenders make higher-priced offers in neighborhoods with fewer adults with college education, and that lenders experience higher rejection rates in such neighborhoods).

<sup>257</sup> See *supra* Sections II.A–II.F.

had no reason to consider the possibility that their loans would become unaffordable and they would default on them. Indeed, even if home prices had continued to rise and borrowers had accumulated equity, borrowers might have found refinancing too costly because of the fees and prepayment penalties involved—something many borrowers apparently failed to realize, representing another TILA failure.<sup>258</sup>

Lenders would have had little need to deceive borrowers about their obligations—by, for example, presenting variable rate loans as fixed<sup>259</sup>—if borrowers would still have entered into those loans even if they had known the truth. A thought experiment makes the point. Suppose lenders had said to borrowers that the borrower would find the loan payments unaffordable relatively soon after the purchase, at which time the borrower would refinance, with the result that the borrower would have more affordable payments until the next change date and the lender would earn additional fees. If, however, for some reason, refinancing was impossible, the borrower could expect to default and be foreclosed upon. Some borrowers probably would have accepted that risk. But it is likely that many would not have. They might instead have purchased less expensive homes to reduce their risk or foregone buying altogether. The result would have been that the economic crisis would not have occurred or would have been less severe. But because it appears that many borrowers failed to appreciate the risk they were taking, this exercise must remain a thought experiment.

#### IV. CONCLUSION

This Article demonstrates that TILA failed to convey to subprime borrowers their payment obligations. First, it explores the disclosure forms and argues that those forms contained misleading numbers for monthly payments for adjustable-rate loan borrowers, making it difficult for borrowers who read the forms to determine whether they could make their payments. Second, the Article reports on a survey of mortgage brokers that indicates that virtually no borrowers withdrew from loans when they saw the final loan terms at the closing, and that many borrowers spent no more than a minute reviewing the Truth in Lending disclosures. It thus appears that consumer protection laws did not give borrowers what they needed to

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<sup>258</sup> The FTC Study found that a significant number of borrowers did not realize that refinancing would trigger a prepayment penalty. LACKO & PAPPALARDO, *supra* note 47, at 36; *see also supra* note 133 for a discussion in the Jacobson and Paschal Affidavits of deceptive tactics used by Wells Fargo loan officers to mislead borrowers as to the nature of prepayment penalties.

<sup>259</sup> *See supra* notes 46, 125 and accompanying text.

recognize that they were assuming loan obligations which they could not satisfy.

The Article argues that society should switch from the regime mandated by the Truth in Lending Act, in which government officials who do not participate in the lending process oblige lenders to make disclosures that they do not care about or may even wish to obscure, to borrowers, who may not appreciate the significance of what they are being given, and so may overlook the disclosures. Furthermore, the Article suggests that society adopt a comprehension regime in which lenders must insure that borrowers understand their loan terms. Alternatively, lending markets should function better if lenders were required to disclose information about the percentage of consumers that understand their loan terms, which might spur competition to improve the intelligibility of loan terms, and even lead to the abandonment of those that few consumers can comprehend.

Because that proposal is politically unfeasible, the Article next suggests some measures to improve the functioning of the existing disclosure regime. Specifically, the Article advocates adoption of “nudges,” after the book of the same name by Cass Sunstein and Richard H. Thaler. Among the nudges suggested by the Article are a video to make more salient to loan applicants the risk of default and foreclosure, and disclosures that would convey the percentage of borrowers with particular loan terms who later defaulted. The Article also urges that loan applicants take the equivalent of a “placement test” on their loan terms; those whose answers revealed that they did not understand their loan terms would not be permitted to borrow until a neutral credit counselor certified that they understand their loan terms.



FIGURE 1: THE FEDERAL RESERVE'S MODEL FORM FOR THE EARLY  
DISCLOSURE OF ADJUSTABLE RATE MORTGAGES FOUND IN 12 C.F.R.  
PART 226 APP. H-4(C).

This disclosure describes the features of the adjustable-rate mortgage (ARM) program you are considering. Information on other ARM programs is available upon request.

*How Your Interest Rate and Payment Are Determined*

- Your interest rate will be based on [an index plus a margin] [a formula].
- Your payment will be based on the interest rate, loan balance, and loan term.
  - [The interest rate will be based on (identification of index) plus our margin. Ask for our current interest rate and margin.]
  - [The interest rate will be based on (identification of formula). Ask us for our current interest rate.]
  - Information about the index [formula for rate adjustments] is published [can be found] \_\_\_\_\_.
  - [The initial interest rate is not based on the (index) (formula) used to make later adjustments. Ask us for the amount of current interest rate discounts.]

*How Your Interest Rate Can Change*

- Your interest rate can change (frequency).
- [Your interest rate cannot increase or decrease more than \_\_\_\_ percentage points at each adjustment.]
- Your interest rate cannot increase [or decrease] more than \_\_\_\_ percentage points over the term of the loan.

*How Your Payment Can Change*

- Your payment can change (frequency) based on changes in the interest rate.
- [Your payment cannot increase more than (amount or percentage) at each adjustment.]
- You will be notified in writing \_\_\_\_ days before the due date of a payment at a new level. This notice will contain information about your interest rates, payment amount, and loan balance.
- [You will be notified once each year during which interest rate adjustments, but no payment adjustments, have been made to your loan. This notice will contain information about your interest rates, payment amount, and loan balance.]

• [For example, on a \$10,000 [term] loan with an initial interest rate of \_\_\_\_ [(the rate shown in the interest rate column below for the year 19 \_\_\_\_)] [(in effect (month) (year))], the maximum amount that the interest rate can rise under this program is \_\_\_\_ percentage points, to \_\_\_\_%, and the monthly payment can rise from a first-year payment of \$ \_\_\_\_ to a maximum of \$ \_\_\_\_ in the \_\_\_\_ year. To see what your payments would be, divide your mortgage amount by \$10,000; then multiply the monthly payment by that amount. (For example, the monthly payment for a mortgage amount of \$60,000 would be:  $\$60,000 \div \$10,000 = 6$ ;  $6 \times \text{____} = \$ \text{____}$  per month.)]

*[Example]*

The example below shows how your payments would have changed under this ARM program based on actual changes in the index from 1982 to 1996. This does not necessarily indicate how your index will change in the future.

The example is based on the following assumptions:

Amount.....\$10,000  
 Term .....  
 Change date.....  
 Payment adjustment .....(frequency)  
 Interest adjustment .....(frequency)  
 [Margin]\* .....  
 Caps \_\_\_\_ [periodic interest rate cap]  
       \_\_\_\_ [lifetime interest rate cap]  
       \_\_\_\_ [payment cap]  
 [Interest rate carryover]  
 [Negative amortization]  
 [Interest rate discount]\*\*

Index.....(identification of index or formula)

\*This is a margin we have used recently, your margin may be different.

\*\*This is the amount of a discount we have provided recently; your loan may be discounted by a different amount.]

Year	Index (%)	Margin (Percentage points)	Interest Rate (%)	Monthly Payment (\$)	Remaining Balance (\$)
1982					
1983					
1984					
1985					
1986					
1987					
1988					
1989					
1990					
1991					
1992					
1993					
1994					
1995					
1996					

Note: To see what your payments would have been during that period, divide your mortgage amount by \$10,000; then multiply the monthly payment by that amount. (For example, in 1996 the monthly payment for a mortgage amount of \$60,000 taken out in 1982 would be:  $\$60,000 \div \$10,000 = 6$ ;  $6 \times \underline{\hspace{1cm}} = \$ \underline{\hspace{1cm}}$  per month.)

## FIGURE 2: A SAMPLE TILA DISCLOSURE FORM FOR A 2/28 HYBRID ADJUSTABLE LOAN

### FEDERAL TRUTH-IN-LENDING DISCLOSURE STATEMENT (THIS IS NEITHER A CONTRACT NOR A COMMITMENT TO LEND)

Loan Number: [REDACTED] Date: NOVEMBER 7, 2006  
 Creditor: [REDACTED]  
 Address: [REDACTED]  
 Borrower(s): [REDACTED]  
 Address: [REDACTED]

Lines containing an "x" are applicable:

ANNUAL PERCENTAGE RATE <small>The cost of your credit as a yearly rate</small>	FINANCE CHARGE <small>The dollar amount the credit will cost you.</small>	Amount Financed <small>The amount of credit provided to you or on your behalf.</small>	Total of Payments <small>The amount you will have paid after you have made all payments as scheduled.</small>	<input type="checkbox"/> Total Sale Price <small>The total cost of your purchase on credit including your down-payment of \$</small>
7.424 %	\$596,082.40	\$351,574.31	\$947,656.71	

PAYMENTS: Your payment schedule will be:

Number of Payments	Amount of Payment **	When Payments Are Due	Number of Payments	Amount of Payment **	When Payments Are Due	Number of Payments	Amount of Payment **	When Payments Are Due
		<small>Monthly Beginning</small>			<small>Monthly Beginning</small>			<small>Monthly Beginning</small>
60	2,060.33	01/01/07						
60	2,244.29	01/01/12						
239	2,872.41	01/01/17						
1	2,873.52	12/01/36						

\_\_\_\_ DEMAND FEATURE: This obligation has a demand feature.

☒ VARIABLE RATE FEATURE: Your loan contains a variable rate feature. Disclosures about the variable rate feature have been provided to you earlier.

INSURANCE: The following insurance is required to obtain credit:  
 \_\_\_\_\_ Credit life insurance and credit disability ☒ Property insurance \_\_\_\_\_ Flood insurance \_\_\_\_\_ Mortgage insurance  
 You may obtain property insurance from any insurer that is acceptable to the Lender.

SECURITY: You are giving a security interest in: [REDACTED] STREET, JAMAICA, NEW YORK 11433  
☒ The goods or property being purchased \_\_\_\_\_ Real property you already own.

FILING FEES: \$ \_\_\_\_\_

LATE CHARGE: If payment is more than 15 days late, you will be charged 2.000 % of the payment.

PREPAYMENT: If you pay off early, you  
 \_\_\_\_\_ may ☒ will not have to pay a penalty.  
 \_\_\_\_\_ may ☒ will not be entitled to a refund of part of the finance charge.

ASSUMPTION: Someone buying your property  
 \_\_\_\_\_ may \_\_\_\_\_ may, subject to conditions ☒ may not assume the remainder of your loan on the original terms.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date and prepayment refunds and penalties.

☒ "x" means an estimate \_\_\_\_\_ all dates and numerical disclosures except the late payment disclosures are estimates.

Each of the undersigned acknowledges receipt of a complete copy of this disclosure. The disclosure does not constitute a contract or a commitment to lend.

Applicant [REDACTED] Date \_\_\_\_\_ Applicant \_\_\_\_\_ Date \_\_\_\_\_  
 Applicant \_\_\_\_\_ Date \_\_\_\_\_ Applicant \_\_\_\_\_ Date \_\_\_\_\_  
 Applicant \_\_\_\_\_ Date \_\_\_\_\_ Applicant \_\_\_\_\_ Date \_\_\_\_\_

\*\* NOTE: Payments shown above do not include reserve deposits for taxes, assessments, and property or flood insurance.